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No. 99-

In The

Supreme Court of the United States

CATERPILLAR INC., CATERPILLAR FINANCIAL SERVICES CORPORATION, AND SOLAR TURBINES INCORPORATED,

Petitioners,

v.

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION AND STANLEY R. ARNOLD, JR., THE NEW HAMPSHIRE COMMISSIONER OF REVENUE,

Respondents.

On Petition For A Writ Of Certiorari To The Supreme Court Of New Hampshire

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether New Hampshire's proposed inclusion of $367,937,664 of foreign unitary income in Caterpillar's apportionable tax base, without including the foreign unitary apportionment factors that generated such income in the denominator of the apportionment formula, discriminates against foreign commerce and massively overstates New Hampshire income by disregarding the unitary business principle and taxing foreign commerce harsher than domestic commerce, in violation of the Commerce Clause?

LIST OF PARTIES

The parties to the proceeding below were the same as those mentioned in the present caption.

In the proceeding below, Solar Turbines Incorporated was referred to as Solar Turbines Inc. The corporation's actual name is Solar Turbines Incorporated and is so referred to herein.

RULE 29.6 STATEMENT

Petitioner Caterpillar Inc. has no parent corporation. There is no publicly held company that owns 10% or more of Petitioner Caterpillar Inc.'s stock.

Petitioner Caterpillar Inc. is the parent corporation of both Petitioner Caterpillar Financial Services Corporation and Petitioner Solar Turbines Incorporated. Other than Petitioner Caterpillar Inc., there is no publicly held company that owns 10% or more of either corporation's stock.

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PETITION FOR A WRIT OF CERTIORARI

This petition for a writ of certiorari respectfully seeks this Court's review of the judgment of the Supreme Court of New Hampshire.

OPINIONS BELOW

The opinion of the Supreme Court of New Hampshire in this case (App. A at 1a-14a) is not officially reported but is reported at 741 A.2d 56. The opinion of the Superior Court of the State of New Hampshire (App. B at 15a-27a) is unreported. The order of the Supreme Court of New Hampshire denying interlocutory transfer (App. C at 28a) is unreported. The Interlocutory Transfer Without Ruling Statement of the Superior Court of the State of New Hampshire (App. D at 29a-72a) is unreported. The opinion and order of the Department of Revenue Administration (App. E at 73a-80a) is unreported.

JURISDICTION

The judgment of the Supreme Court of New Hampshire was entered on October 25, 1999. The jurisdiction of this Court rests upon 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

Relevant portions of the New Hampshire statutes are set forth in App. D at 35a-56a.

STATEMENT

The cornerstone of this case is discriminatory, extra-territorial taxation against foreign commerce. The key to revealing the constitutional violation is comparing what happens when a domestic parent corporation, such as Caterpillar, moves a unitary subsidiary from within the United States to a foreign country. When this happens, the New Hampshire tax imposed on Caterpillar's limited New Hampshire activities is significantly, systematically and inevitably increased. This increase occurs because while New Hampshire acknowledges the unitary business principle for domestic commerce – by including in the tax computation the royalties and interest received from domestic unitary subsidiaries with full factor representation – it disregards the unitary business principle for foreign commerce – by including in the tax computation the royalties and interest received from foreign unitary subsidiaries with no factor representation.[1] This less

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[1] New Hampshire law requires that payments made to a parent company by a unitary domestic subsidiary be (1) eliminated from the parent's income and the subsidiary's deductions, (2) deemed shifted back to the subsidiary as if they had not been made, and (3) included in the water's edge group's combined income, as restored income of the subsidiary. The domestic subsidiary's property, payroll and sales are included in the group's apportionment factor computation to reflect the sources of the subsidiary's income.

By contrast, royalty and interest payments by a unitary foreign subsidiary to a parent company are not eliminated from the parent's income and are not shifted back as restored income of the subsidiary. Instead, the payments are included in the water's edge group's combined income, as income of the parent, without including in the apportionment factor computation *any* portion of the property, payroll and sales of the foreign

favorable treatment is based solely on the foreign location of the subsidiary.

To illustrate the discrimination involved herein, assume Company A has a subsidiary, Subsidiary Y, that is located exclusively in Maine and with which it is engaged in a unitary business. Subsidiary Y has $300 million of income, all of which it pays to Company A in the form of royalties and interest in the year it is earned. Subsidiary Y also has $1 billion of property, $1 billion of payroll, and $1 billion of sales. The New Hampshire apportionable income base will include the $300 million of Subsidiary Y's unitary income and the $1 billion each of the property, payroll and sales of Subsidiary Y will be included in the denominator of the New Hampshire apportionment formula.

Now assume that Subsidiary Y moves across the St. Lawrence River to Quebec and that all of the other facts remain the same. The New Hampshire apportionable income base will still include the $300 million of Subsidiary Y's unitary income. However, none of the $1 billion each of property, payroll or sales of Subsidiary Y will now be included in the denominator of the New Hampshire apportionment formula. Such a result, based solely on the location of the subsidiary, dramatically increases Company A's New Hampshire tax and discriminates against foreign commerce in violation of the Foreign Commerce Clause.

The discrimination is all the more egregious in the instant case since, for the three years in issue, the combined New Hampshire payroll of the Caterpillar group was only $193,215 ($77,091, $55,718 and $60,406, respectively), yet the state wants to tax $367,937,664 of foreign

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subsidiary, even though those factors are the sources of the unitary funds from which the intragroup payments are made.

unitary income over that same period ($329,255,832 in foreign royalties and $38,681,832 in foreign interest) without any factor representation of the foreign unitary subsidiaries that generated such income.

New Hampshire does not impose a sales tax. It does not impose a personal income tax. The state's motto is "Live Free or Die." Is it the state's position that only its citizens are to live free and that out-of-state corporations must pay discriminatory, extraterritorial taxes that bear no relationship to their New Hampshire activities? Such overreaching and discrimination by the state should not be permitted.

To avoid this unconstitutional discrimination, the foreign income should be excluded from the computation of the New Hampshire tax, consistent with the unitary business principle. Alternatively, if such large amounts of foreign income are included in the tax base, then, consistent with the unitary business principle, some portion of the substantial property, payroll and sales of the foreign unitary subsidiaries that generated the royalties and interest should be considered in apportioning the income for taxation by New Hampshire.

The issue of whether a state may include unitary income in the tax base without providing any representation in the apportionment formula of the factors that generated such income affects virtually every state with a corporate income tax. Like New Hampshire, the overwhelming majority of states include intangible income that a corporate taxpayer receives from foreign unitary subsidiaries in the taxpayer's apportionable tax base.[2]

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[2] The vast majority of states use federal taxable income as the starting point for calculating state taxable income. 1 State Tax Guide (CCH) ¶ 10-108 (2d ed. 1999). The federal tax base

Like New Hampshire, the overwhelming majority of states fail to provide statutorily for "factor representation" when such unitary income is included in a taxpayer's unitary apportionable tax base.

The issue was noted by Justice Stevens in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), where he stated:

> Unless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause Mobil's Vermont income to be overstated.

Mobil, 445 U.S. at 461 (Stevens, J., dissenting). This issue was also identified in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 168 n.5 (1983).

This Court has never specifically addressed this issue. The state courts are divided with some courts holding that factor representation is required while others have held to the contrary. This is an issue that needs to be addressed to provide necessary guidance and certainty to the state courts, to the state departments of revenue and, most importantly, to all taxpayers.

1. Caterpillar's Unitary Business and its Limited New Hampshire Activities

The facts of this case, which were stipulated, are not in dispute. Petitioner Caterpillar Inc. is a Delaware corporation with its corporate headquarters and principal place

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generally includes payments, such as royalties and interest, made by foreign affiliates to their domestic affiliates. I.R.C. § 61. Therefore, unless explicitly excluded, such foreign payments are included in the apportionable tax base in most states.

of business in Peoria, Illinois. It is engaged in the manufacture and sale of engines and earth-moving equipment in the United States and various foreign countries.

During each of the years at issue, Caterpillar Inc. owned over 50 domestic and foreign (non-U.S.) subsidiaries and affiliates. (Stip. ¶ 1.) Caterpillar Inc. and all of its subsidiaries, both domestic and foreign, and affiliates were engaged in a single "unitary business" during 1987, 1988 and 1989 (the "Caterpillar Unitary Business"). (Stip. ¶ 1.)

Of all the members comprising the Caterpillar Unitary Business, only three corporations – Caterpillar Inc., Caterpillar Financial Services Corporation, and Solar Turbines Incorporated (together, "Caterpillar" or "Petitioners") – conducted business in New Hampshire during the tax years. (Stip. ¶ 7.) Their New Hampshire business activities were limited to the ownership of personal property and the solicitation of sales to unrelated, independent dealers in New Hampshire. (Stip. ¶ 7.) No members of the Caterpillar Unitary Business were domiciled in New Hampshire during the tax years at issue. (Stip. ¶ 7.)

Caterpillar's foreign subsidiaries and affiliates (the "Foreign Unitary Members") made substantial royalty and interest payments to their parent and certain domestic subsidiaries.[3]

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[3] For the years in question, the royalties and interest paid by the Foreign Unitary Members were as follows:

Year	*Royalties*	*Interest*
1987	$115,072,809	$ 9,261,564
1988	$131,765,387	$ 9,855,844
1989	$ 82,417,636	$19,555,229

2. New Hampshire's Taxing Scheme

New Hampshire imposes a Business Profits Tax on corporations pursuant to a "water's edge combined group" reporting method. Under this water's edge method, the federal taxable income of each domestic unitary group member, after making certain adjustments not at issue herein, is combined to produce "New Hampshire Combined Net Income." (Stip. ¶ 17 Step 1.A.) Intercompany payments made by and between *domestic unitary* subsidiaries are eliminated from the calculation of net income as if they had not been made. (Stip. ¶ 17 Step 1.A.) Intercompany payments, such as royalty and interest payments, made by *foreign unitary* subsidiaries, however, are included in, and are not eliminated from, net income. (Stip. ¶ 17 Step 1.A.) This combined net income becomes New Hampshire's tax base subject to apportionment.

When a company such as Caterpillar conducts business both within and without New Hampshire, the state apportions business profits to the state using a formula which purports to tax only that income which is fairly attributable to New Hampshire. N.H. Rev. Stat. Ann. § 77-A:3. This provision is consistent with the Commerce Clause requirement that income apportioned to a state not be out of proportion to the business transacted in the state. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164-65 (1983).

New Hampshire employs a standard three-factor formula used by many states to apportion income. Each factor has a numerator, which reflects property, payroll, and sales in New Hampshire, and a denominator which reflects the total property, payroll, and sales of *domestic unitary group members only*. The average of the three factors is then applied against the New Hampshire tax base

and the result purportedly determines the portion of a corporation's income which is fairly attributable to and taxable by New Hampshire. None of the property, payroll or sales of the foreign unitary group members is included in the calculation.

The New Hampshire formula purports to determine the "slice" of the apportionable "pie" of *unitary* business income that is fairly attributable to New Hampshire. For example, investment income paid to a unitary business from a non-unitary subsidiary or a non-unitary unrelated third party may not be included in apportionable income. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 330 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M.*, 458 U.S. 354, 364 (1982).

3. The Assessment

The New Hampshire Department of Revenue Administration (the "Department") conducted an audit of Caterpillar's books and records for the tax years 1987, 1988, and 1989. As a result of that audit, the Department issued a Notice of Assessment claiming Caterpillar owed additional Business Profits Tax for the years in question. The proposed additional tax was based upon the Department's determination that Caterpillar should have included in its gross business profits the royalty and interest payments received from the Foreign Unitary Members without including any of the property, payroll or sales of the Foreign Unitary Members in the computation of the apportionment formula.

The Department treated all such foreign royalties and interest as "gross business profits" under the Business Profits Tax statute. *See* N.H. Rev. Stat Ann. § 77-A:1, III(a).

In calculating the proposed additional tax, the Department added these foreign royalty and interest payments (which totaled $367,928,469) to Petitioners' tax base and refused to add any of the foreign income producing factors to the apportionment formula, thereby discriminating and automatically taxing income not earned within New Hampshire in violation of the Commerce Clause.

4. The Proceedings Below

How the federal question was raised and passed on below. In Petitioners' protest before the Department and in their memoranda before the Department, in their briefs before the New Hampshire Superior Court and in their briefs before the Supreme Court of New Hampshire, Petitioners contended that the Department's determination was invalid under the Commerce Clause of the United States Constitution. The Hearing Officer noted Petitioners' objections but, citing a lack of jurisdiction to decide an issue on constitutional grounds, did not rule on those objections. App. E at 75a & 76a. The courts explicitly noted and ruled on Petitioners' objections. App. A at 3a, 7a-8a & 13a-14a; App. B at 15a, 16a, 21a & 27a.

The decisions below. In September, 1991 Petitioners commenced this action by timely filing a protest asserting, *inter alia*, that the Department's determination violated the Commerce Clause of the United States Constitution. App. A at 3a; App. B at 16a; App. E at 75a & 76a; Stip. ¶ 18. Following a hearing, the Department's Hearing Officer issued a Final Order which refused to grant Petitioners' relief as requested, citing a lack of jurisdiction to decide an issue on constitutional grounds. App. A at 3a; App. B at 16a; App. E at 76a; Stip. ¶ 18.

Petitioners thereafter timely requested review by the New Hampshire Superior Court of the Department's

assessment and demand. Before the review was granted, the parties jointly moved to have this matter transferred to the New Hampshire Supreme Court, which motion was denied. App. B at 16a; App. C at 28a. Petitioners subsequently moved for summary judgment on the basis that taxation of foreign unitary income without factor representation was unconstitutional. App. B at 16a & 21a. After a hearing, the Superior Court denied Petitioners' motion, holding that "New Hampshire water's edge method of business profits taxation does not violate the Commerce Clause of the Federal Constitution." App. B at 27a.

Petitioners subsequently appealed the denial of summary judgment to the Supreme Court of New Hampshire, arguing that N.H. Rev. Stat. Ann. § 77-A facially discriminates against foreign commerce in violation of the Commerce Clause. App. A at 3a & 7a-8a. The Supreme Court of New Hampshire affirmed the lower court's grant of summary judgment to the Department, holding that "[t]he nature of the water's edge formula requires that foreign subsidiaries be treated differently from domestic subsidiaries: most significantly, the latter's income is subject to taxation while the former's income is not." App. A at 13a-14a. The New Hampshire Supreme Court further held that "the proper comparison [in considering claims of discriminatory taxation under the Commerce Clause] is between foreign members of the unitary group and unrelated domestic entities." App. A at 10a.

REASONS FOR GRANTING THE PETITION

The decision of the Supreme Court of New Hampshire warrants review by this Court. The lower court's

holding permits New Hampshire to engage in discriminatory, extraterritorial taxation in contravention of the Commerce Clause and decisions of this Court. The lower court's ruling to allow the inclusion of unitary foreign royalties and interest in the tax base without unitary factor representation ignores the unitary business principle, ignores this Court's decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992), addresses issues left open by this Court in *Mobil* and *Container*, and involves an issue where the state court decisions are neither consistent nor uniform. Finally, the lower court's decision is inconsistent with decisions of the New York Court of Appeals, the Supreme Judicial Court of Maine, the Supreme Court of Rhode Island, the Supreme Court of Oregon, the Court of Appeals of Maryland, the Supreme Court of South Carolina, and the Supreme Court of New Jersey.

I.

THE STATE'S TAXATION OF UNITARY FOREIGN INCOME, WITHOUT FACTOR REPRESENTATION, RESULTS IN DISCRIMINATORY, EXTRATERRITORIAL TAXATION OF INCOME THAT HAS NO RELATIONSHIP TO NEW HAMPSHIRE

A. The Lower Court's Decision Ignores the Unitary Business Principle and is Inconsistent with this Court's Decisions in *Mobil* and *Container*.

In *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), this Court stated that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." 445 U.S. at 439 (footnote omitted). In *Mobil* this Court held that a state could

constitutionally include payments made by unitary foreign subsidiaries in the recipient corporation's apportionable income (Part A of the unitary business principle). However, because the issue had not been timely raised, this Court stated in *Mobil* that it was not considering Part B of the unitary business principle – *i.e.*, that inclusion of such amounts in apportionable income without factor representation was not constitutionally permissible. *Mobil*, 445 U.S. at 441 n.15, 449.

Justice Stevens directly addressed the merits of the Part B issue. He concluded that Vermont failed to apportion fairly Mobil's income from its unitary foreign subsidiaries because the state had not taken into account the subsidiaries' property, payroll and sales that generated that income. *See Mobil*, 445 U.S. at 449-62 (Stevens, J., dissenting). Specifically, Justice Stevens concluded that the denominator of the apportionment formula had to be adjusted, stating:

> *Unless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula,* the inclusion of earnings attributable to those corporations in the apportionable tax base will *inevitably cause Mobil's Vermont income to be overstated.*

Mobil, 445 U.S. at 461 (Stevens, J., dissenting) (emphasis added).

This issue was also specifically identified in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 164-65 (1983). There the worldwide combined reporting method required by California (which eliminated from the taxpayer's income all payments to the taxpayer from its unitary foreign subsidiaries and included 100 percent of the income and factors of the foreign subsidiaries in the apportionment formula) was contrasted with the

approach used by Vermont in *Mobil* (which, like New Hampshire, included payments from the taxpayer's unitary foreign subsidiaries in its apportionable income, but did not reflect those subsidiaries' property, payroll, and sales in its apportionment fraction). *Container Corp.*, 463 U.S. at 167-69.

As this Court observed, the requirement of factor representation derives from the bedrock principle that "an apportionment formula must, under both the Due Process and Commerce Clauses, be fair." *Id.* at 169. In this discussion, it was noted that fair apportionment required that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income was generated," *id.*, and specifically noted Justice Stevens' dissenting opinion in *Mobil*:

> Some States, it should be noted, have adopted a *hybrid approach*. In *Mobil* itself, for example, a nondomiciliary State invoked a unitary business justification to include an apportioned share of certain corporate dividends in the gross income of the taxpayer, but did not require a combined return and combined apportionment. The Court in *Mobil* held that the taxpayer's objection to this approach had not been properly raised in the state proceedings. *Justice STEVENS, however, reached the merits*, stating in part: "Either Mobil's worldwide 'petroleum enterprise' is all part of one unitary business, or it is not; if it is, Vermont must evaluate the entire enterprise in a consistent manner."

Container Corp., 463 U.S. at 168 n.5 (citations omitted, emphasis added).

The very heart of this case is the lack of a consistent application of the unitary business principle. New Hampshire is evaluating Caterpillar in an inconsistent manner that violates the unitary business principle since even

though it includes in Caterpillar's tax base the foreign royalties and interest received from the Foreign Unitary Members, it refuses to include any of the property, payroll and sales of such Foreign Unitary Members for purposes of applying the formula apportionment rules. By including the royalties and interest of the Foreign Unitary Members without the same apportionment allowed to income of the Domestic Unitary Members, New Hampshire has eviscerated the unitary business principle.

New Hampshire cannot pick and choose which part of the unitary business principle it will apply (Part A) and which part it will disregard (Part B). Either New Hampshire should not include the foreign royalties and interest in the tax base or, if it includes such unitary payments in the base, it should include the factors of the unitary corporations that generated such amounts in the calculation of the apportionment formula. The unitary business principle does not allow states to cherry pick.

Caterpillar does not argue that the use of a standard, three-factor apportionment formula is an unfair or unreasonable method of determining Caterpillar's income taxable by New Hampshire. Rather, it is the state's overreaching and its modification of the unitary business principle, by including in the tax base unitary foreign royalties and interest while at the same time excluding from the apportionment formula the unitary foreign factors that generated such amounts, to which Caterpillar objects.

New Hampshire's disregard of the unitary business principle serves only to increase tax dollars received by the state by increasing the tax base using sources of income which have no connection or relationship to New Hampshire. Such a method of taxation is both unfair and

unreasonable and results in discriminatory, extraterritorial taxation of income that has no relationship to New Hampshire in violation of the Commerce Clause.

B. The Lower Court's Decision to Disregard the Unitary Business Principle, By Including Foreign Royalties and Interest in the Tax Base Without Factor Representation, Results in Inevitable Discrimination Against Foreign Commerce, a Result that is Inconsistent With this Court's Decision in *Kraft*.

To survive scrutiny under the Commerce Clause, a challenged tax must: (1) be applied to an activity with a substantial nexus with the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce; *and* (4) be fairly related to the services provided by the state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). A tax can be found invalid under the third prong of *Complete Auto* "if it is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce." *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 75 (1989).

In *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992), this Court held that Iowa's corporate income tax scheme facially discriminated against foreign commerce in violation of the Foreign Commerce Clause. This was because Iowa's tax base included income received in foreign commerce, but not income received in domestic commerce. Iowa's tax scheme therefore improperly "impose[d] a burden on foreign subsidiaries that it [did] not impose on domestic subsidiaries." *Kraft*, 505 U.S. at 80.

The lower court's decision to disregard Part B of the unitary business principle similarly results in discrimination against foreign commerce. This is because a burden

is being imposed on Caterpillar's foreign subsidiaries that is not being imposed on Caterpillar's domestic subsidiaries.

The following diagrams demonstrate the discriminatory effect of New Hampshire's tax scheme. Diagram A shows the impact of limiting the application of the unitary business principle to the "water's edge." All the income and apportionment factors of "overseas business organizations" (*i.e.*, non-U.S. subsidiaries of the unitary business) are excluded from the apportionment and tax computations of the water's edge combined group. Accordingly, the income base excludes foreign income and the denominators of the apportionment fractions exclude the property, payroll and sales activities of the foreign unitary members. Diagram A reflects a "true" water's edge combined reporting method.

Diagram A – Water's Edge Apportionment

Water's Edge Apportionment Factors

	Property	Payroll	Sales
NH (Numerator)	10	5	1
Everywhere (Denominator)	50	50	50
Factor	20%	10%	2%
NH Apportionment Fraction:		10.66%	

Water's Edge Income Apportionment

Water's Edge Unitary Income:	$500.00
NH Apportionment Fraction:	10.66%
NH Taxable Income:	$53.30

When foreign unitary income is included in the tax base, a substantial overstatement of New Hampshire income will inevitably result if the factors that generated that unitary income are excluded from the operation of the apportionment formula. The effect of this substantial overstatement is illustrated in the following diagram.

Diagram B – Inevitable Overstatement of Income

Water's Edge Apportionment Factors

	Property	Payroll	Sales
NH (Numerator)	10	5	1
Everywhere (Denominator)	50	50	50
Factor	20%	10%	2%
NH Apportionment Fraction:		10.66%	

Water's Edge Income Apportionment

Water's Edge Unitary Income:	$500.00
Foreign Unitary Income:	$500.00
Total Unitary Income:	$1,000.00
NH Apportionment Fraction:	10.66%
NH Taxable Income:	$106.60

The failure to include any of the income producing factors of the foreign unitary group members leaves the New Hampshire apportionment fraction – based solely on the property, payroll and sales factors of the domestic unitary group members – unchanged. The unitary income subject to apportionment, however, now includes the foreign unitary income.

The resulting overstatement of income apportioned to New Hampshire as a result of this taxation of foreign

unitary income "without factor representation" is inevitable and dramatic. When foreign royalty and interest payments become subject to apportionment, none of the apportionment factors that generated the foreign royalties and interest is added to the denominators. The fundamental relationship between income of a unitary business and fair apportionment is broken. This system of taxation without factor representation uniquely burdens the foreign operations of the unitary business.

By denying the rational relationship between unitary income and formula apportionment, the inescapable consequence is that the New Hampshire tax will increase. Indeed, the scope of discriminatory treatment of foreign unitary operations is limitless. One has only to imagine what would occur if foreign unitary income in the form of royalties and interest were to double or triple, with no corresponding change in the unitary business's New Hampshire activities. New Hampshire's disregarding of Part B of the unitary business principle would result in significant increases in the amount of income subject to New Hampshire tax, despite the fact that the enterprise's New Hampshire activities did not vary at all. Indeed, under some circumstances, the New Hampshire Business Profits Tax liability could increase *even while the enterprise's New Hampshire property, payroll and sales were decreasing*.

As illustrated above, a substantial overstatement of New Hampshire income is the inevitable result when foreign unitary royalties and interest are included in the tax base but the factors that generated such unitary income are excluded from the operation of the apportionment formula. Such a substantial overstatement has occurred here in violation of the Foreign Commerce Clause. To avoid this discriminatory result, the foreign

income should be excluded from the tax base or, alternatively, factor representation should be provided.

C. The Lower Court's Decision to Disregard the Unitary Business Principle, By Including Foreign Royalties and Interest in the Tax Base Without Factor Representation, Results in Extraterritorial Taxation of Income that has No Relationship To New Hampshire.

New Hampshire seeks to tax $367,928,469 of foreign royalties and interest, without factor representation, none of which has any relationship to the state or to the limited business activities conducted by Petitioners in New Hampshire. The state should not be permitted to engage in such extraterritorial taxation. In *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 777 (1992), this Court re-affirmed the basic principle of taxation that a state may not tax income earned outside its borders. Both the Due Process and Commerce Clauses impose this limitation on a state's taxing authority and both Clauses require " 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.' " *Id.* (citation omitted).

In *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931), this Court struck down the application of an apportionment formula when the formula resulted in the taxation of income earned outside the state's borders. In so holding, this Court stated that:

> the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as "component parts of a single unit" so that the entire net income may be

> taxed in one state regardless of the extent to which it may be derived from the conduct of the enterprise in another state.

Id. at 133. Since the statutory apportionment formula attributed to the state "a percentage of income out of all appropriate proportion to the business transacted by the [taxpayer] in that state," *id.* at 135-36, the imposition of the tax was beyond the state's authority.

In *Container Corp.*, this Court stated that, to pass constitutional muster, an apportionment formula must be fair. 463 U.S. at 169. In order to be considered fair under both the Commerce and Due Process Clauses, a state's apportionment formula must be consistent, both internally and externally. *Container Corp.*, 463 U.S. at 169-70. External consistency mandates that a state's apportionment formula must reflect a "reasonable sense of how income is generated." *Id.* at 169. Citing to *Hans Rees' Sons*, this Court stated that it would strike down an apportionment formula that was shown to be "out of all appropriate proportion[ ] to the business transacted . . . in that State." *Id.* at 170.

Recently, the New York Court of Appeals, relying on these principles, held that it was improper to subject to New York's apportionment formula the gain realized by a nondomiciliary corporation from the sale of Baltimore real estate that was part of its unitary business. *British Land (Md.), Inc. v. Tax Appeals Tribunal of N.Y.*, 85 N.Y.2d 139, 647 N.E.2d 1280 (1995). The court found that even though the income arose from the taxpayer's unitary business, its inclusion in the apportionment formula was improper because the "gain on the sale of the Baltimore property 'cannot in fairness be attributed to [petitioner's] activities within [New York] State' (*Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 US, at 780, supra)." *British Land*, 85 N.Y.2d at 149, 647 N.E.2d at 1285.

It is undisputed that, for the years at issue, only three of the more than fifty corporations comprising the Caterpillar Unitary Business conducted any business whatsoever in New Hampshire. (Stip. ¶¶ 4 & 7.) Neither Caterpillar Inc. nor any of its domestic unitary subsidiaries (the "Domestic Unitary Members"), which number more than twenty, were domiciled in New Hampshire. (Stip. ¶ 7.)

Out of more than thirty-five foreign subsidiaries and affiliates which were included in the Caterpillar Unitary Business (*i.e.*, the Foreign Unitary Members), not a single one transacted any business within New Hampshire. (Stip. ¶ 7.) They did not seek out nor receive any benefits conferred by New Hampshire nor did they have any contact with the state. In sum, the Foreign Unitary Members did not have any link or relationship with New Hampshire.

Caterpillar's combined New Hampshire payroll during the entire three years at issue herein totaled a mere $193,215. Despite Caterpillar's limited activities in New Hampshire, and despite the lack of any New Hampshire activities whatsoever by any of Caterpillar's foreign subsidiaries and affiliates, New Hampshire wants to include in the tax base almost $370 million of foreign royalties and interest.

External consistency does not exist in this case. The appropriate remedy for such unfair and unconstitutional overreaching by New Hampshire is the exclusion of the foreign royalties and interest from the tax base. Alternatively, if the foreign royalties and interest are included in the tax base, then the unitary business principle requires that the factors that generated such amounts be included in the calculation of the formula that is used to

apportion the income. Therefore, inasmuch as the decision below is inconsistent with decisions of this Court, as well as a decision of the New York Court of Appeals, it merits review by this Court.

II.

THE STATE COURT'S HOLDING THAT FOREIGN UNITARY ROYALTIES AND INTEREST MAY BE INCLUDED IN THE APPORTIONABLE TAX BASE WITHOUT FACTOR REPRESENTATION INCORRECTLY COMPARES CATERPILLAR'S FOREIGN UNITARY MEMBERS TO UNRELATED THIRD PARTIES, INCREASES THE CONFLICT AMONG THE STATE COURTS, AND OPENS THE DOOR TO AN UNCHECKED ABILITY OF STATES TO IMPERMISSIBLY TAX FOREIGN COMMERCE

A. The Lower Court's Comparison of the Foreign Unitary Members With Unrelated Domestic Payors of Royalties and Interest is Inconsistent With Decisions of this Court; the Proper Comparison is Between the Foreign Unitary Members and their Domestic Unitary Counterparts that are not Doing Business In New Hampshire.

The New Hampshire Supreme Court concluded that for purposes of determining whether New Hampshire's tax scheme discriminates against foreign commerce "the proper comparison is between the foreign members of the unitary group and unrelated domestic entities." App. A at 10a. The lower court is wrong. The proper comparison is between the Foreign Unitary Members (none of which are doing business in New Hampshire) and the Domestic Unitary Members that are not doing business in New Hampshire.

The relevant *substantive* characteristic of the disputed royalties and interest is that they are paid by foreign

entities *stipulated by the parties to be unitary. Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164-65 (1983), leaves no doubt about the substantive and persisting nature of a unitary relationship – a relationship which exists notwithstanding the water's edge filing method. The lower court stated that, under the water's edge method, foreign unitary subsidiaries are considered unrelated businesses. Yet, the water's edge method cannot eviscerate the unitary business principle.

Therefore, the unitary character of the Foreign Unitary Members is the characteristic that must be taken into account in devising the proper comparison for the Foreign Commerce Clause analysis. Consequently, the proper comparison is between the Foreign Unitary Members and their *domestic unitary counterparts that are not doing business in New Hampshire. See, e.g., General Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997) ("any notion of discrimination assumes a comparison of substantially similar entities" (footnote omitted)); *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin.*, 505 U.S. 71, 80 n.23 (1992) ("In considering claims of discriminatory taxation under the Commerce Clause, however, it is necessary to compare the taxpayers who are 'most similarly situated.' " (citing *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 71 (1963))).

When this proper comparison is utilized, there is no escaping the conclusion that the inclusion of the foreign royalties and interest in the tax base without factor representation is discriminatory and unconstitutional. *See Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 647 (1994) (This Court has "applied a 'virtually per se rule of invalidity' to provisions that patently discriminate against interstate trade." (Citation omitted.)).

The facial discrimination inherent in New Hampshire's taxation of royalty and interest payments by the Foreign Unitary Members is succinctly demonstrated by the paradigm fact pattern of *Kraft*, set forth in footnote 10 as follows:

> "If an Iowa parent company had a Kentucky subsidiary, [that] did all of its business in Kentucky, and another subsidiary that did all its business in Germany, Iowa would not tax the income of either of those subsidiaries. If each paid a dividend to the Iowa parent, Iowa would tax the German dividends and would not tax the Kentucky dividends."

505 U.S. at 74 n.10 (citation omitted). In striking down Iowa's taxation of the dividends paid by the German subsidiary in the above example, the Court generally struck down less favorable treatment of foreign commerce.

One need not change the foregoing example to illustrate how New Hampshire's taxation of foreign royalty and interest payments is equally facially discriminatory. If the Kentucky subsidiary paid royalties and interest to a New Hampshire parent, those payments would have been eliminated, the income from which they were paid would have been included in the tax base and the Kentucky subsidiary's property, payroll and sales would have been included in the denominator of the New Hampshire apportionment formula. However, if the royalty and interest paying subsidiary were located in Germany, the New Hampshire tax base would have included the royalties and interest without factor representation – *i.e.*, none of the German subsidiary's property, payroll, and sales would have been included in the denominator of the apportionment fraction. This facially different and detrimental treatment of the apportionment and taxation of

income of foreign unitary subsidiaries as compared to the apportionment and taxation of income of domestic unitary subsidiaries is as constitutionally prohibited as was the discriminatory taxation of dividends in *Kraft*.

As the foregoing demonstrates, the proper comparison is between the Domestic Unitary Members that are not doing business in New Hampshire, whose unitary income is subject to apportionment with full factor representation, and the Foreign Unitary Members, whose income, when paid in the form of royalties and interest, is subject to apportionment without factor representation. Consequently, the constitutional violation is inescapable.

B. The Lower Court's Comparison of the Foreign Unitary Members With Unrelated Domestic Payors of Royalties and Interest Erroneously Assumes that Payments from Unrelated Domestic Payors Would Automatically Be Includable In Caterpillar's Tax Base.

In asserting that the payments by Caterpillar's Foreign Unitary Members should be compared to payments by unrelated domestic entities (App. A at 10a), the New Hampshire Supreme Court assumed that all royalty and interest payments by unrelated third parties would automatically be includable in Caterpillar's apportionable tax base. This assumption is incorrect.

A state may apportion income received by a nondomiciliary corporation if (1) the taxpayer corporation is engaged in a unitary business with the payor corporation, or (2) the transaction serves an operational rather than an investment function of the taxpayer corporation. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 787 (1992).

The payments from the Foreign Unitary Members, if includable at all in Caterpillar's New Hampshire tax base, are includable only because of the existence of the stipulated unitary relationship. Payments from third parties, however, never satisfy the unitary business relationship requirement. Since payments by third parties of royalties and interest can serve an investment function of the recipient corporation, the lower court's assumption that all payments by unrelated third parties would be includable in the apportionable tax base is incorrect.

Therefore, the proper comparison is between the Foreign Unitary Members and the Domestic Unitary Members that are not doing business in New Hampshire. There is always factor representation with respect to the Domestic Unitary Members that are not doing business in New Hampshire. Accordingly, with respect to the Foreign Unitary Members, factor representation should also be required.

C. The Lower Court Decision Adds To The Existing Confusion Among the State Courts Regarding Factor Representation.

Although this Court has not directly addressed whether and when a taxpayer is entitled to factor representation in order to comport with constitutional standards, the issue of factor representation has been addressed by the courts of many states. The conclusions reached by the various state courts are inconsistent.

The New Hampshire Supreme Court held below that factor representation is unnecessary in apportioning income paid by foreign entities. The lower court decision adds to the existing confusion and highlights the need for certainty among the states.

The Supreme Judicial Court of Maine, the Supreme Court of Rhode Island, the Supreme Court of Oregon, the Court of Appeals of Maryland, the Supreme Court of South Carolina, the Supreme Court of New Jersey, the Commonwealth Court of Pennsylvania, the Wisconsin Court of Appeals and the Wisconsin Tax Appeals Commission have all addressed the issue of factor representation and determined that consideration must be given to inclusion in the apportionment formula of at least some of the factors that generate the items that are included in the tax base. *Tambrands, Inc. v. State Tax Assessor*, 595 A.2d 1039 (Me. 1991); *E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, 88 (Me. 1996); *Homart Dev. Co. v. Norberg*, 529 A.2d 115 (R.I. 1987); *Crocker Equip. Leasing, Inc. v. Department of Revenue*, 314 Or. 122, 838 P.2d 552 (1992); *NCR Corp. v. Comptroller*, 313 Md. 118, 544 A.2d 764 (1988); *NCR Corp. v. South Carolina Tax Comm'n*, 304 S.C. 1, 402 S.E.2d 666 (1991), *appeal after remand*, 312 S.C. 52, 439 S.E.2d 254 (1993), *cert. denied*, 512 U.S. 1245 (1994); *F.W. Woolworth Co. v. Director of Div. of Taxation*, 45 N.J. 466, 213 A.2d 1 (1965); *Unisys Corp. v. Pennsylvania*, 726 A.2d 1096 (Pa. Commw. Ct. 1999); *AT&T v. Wisconsin Dep't of Revenue*, 143 Wis. 2d 533, 422 N.W.2d 629 (Ct. App. 1988); *NCR Corp. v. Wisconsin Dep't of Revenue*, Nos. I-8669 & 87-I-359 (Wis. Tax Appeals Comm'n Mar. 13, 1992).

On the other side of the factor representation coin, however, are the Court of Appeals of New Mexico, the Supreme Judicial Court of Massachusetts, the Supreme Court of Mississippi, the Supreme Court of Kansas, the Supreme Court of Minnesota and an Appellate Court of Illinois. These state courts have determined that factor representation is not required. *NCR Corp. v. Taxation & Revenue Dep't of N.M.*, 115 N.M. 612, 856 P.2d 982 (Ct.

App. 1993), *cert. denied*, 512 U.S. 1245 (1994); *Gillette Co. v. Commissioner of Revenue*, 425 Mass. 670, 683 N.E.2d 270 (1997); *Ashland Pipe Line Co. v. Marx*, 623 So. 2d 995, 1004 (Miss. 1993); *In re Morton Thiokol, Inc.*, 254 Kan. 23, 864 P.2d 1175 (1993); *NCR Corp. v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn.), *cert. denied*, 493 U.S. 848 (1989); *Caterpillar, Inc. v. Commissioner of Revenue*, 568 N.W.2d 695, 701 (Minn. 1997), *cert. denied*, 522 U.S. 1112 (1998); *Caterpillar Fin. Servs. Corp. v. Whitley*, 288 Ill. App. 3d 389, 400, 680 N.E.2d 1082, 1088 (3d Dist.), *appeal denied*, 174 Ill. 2d 556, 686 N.E.2d 1158 (1997).

Caterpillar itself has had different outcomes on the very same issue addressed below. In Minnesota and Illinois, the state courts found that the foreign royalties and interest could be included in the tax base without the inclusion of any of the factors of the Foreign Unitary Members in the computation of the apportionment formula. In Florida, however, the Circuit Court issued an Order Deferring Ruling in which it expressed its view that the Florida tax scheme, which is similar to New Hampshire's, had "a potential constitutional defect." The court stated that Petitioners and another domestic affiliate had

> advanced a persuasive argument that the Florida consolidated reporting method discriminates against foreign commerce by making an arbitrary distinction between domestic and foreign income. In support of this argument they rely on *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 112 S.Ct. 2365 (1992), a case that is difficult to distinguish. In this case as in *Kraft*, the system of apportionment appears to overstate foreign income in relation to the total taxable income attributable to the activities of the taxpayer in the State of Florida.

App. F at 82a. The case was ultimately settled.

The foregoing decisions demonstrate the confusion of the state courts and the uncertainty faced by taxpayers across the nation with respect to factor representation. The New Hampshire Supreme Court's decision only serves to further the confusion and uncertainty. It is therefore imperative that the Court address the issue of factor representation and eliminate the chaos that currently permeates through the state courts.

D. If Allowed to Stand, New Hampshire's Decision Will Open the Door to an Unchecked Ability of the States to Impermissibly Tax Foreign Commerce.

The decision below poses a serious threat to constitutional restraints on state taxation of international commerce by allowing a state to tax indirectly what it is not permitted to tax directly. *See Passenger Cases*, 48 U.S. 282, 458 (1849). The decision will open the floodgates to a wave of unlimited taxation of foreign income to which the states have no connection. If left undisturbed, there is no telling where the states will draw the line between income which is taxable and that which is unreachable.

The Supreme Court of New Hampshire's decision to tax foreign income without factor representation has implications for every taxpayer that conducts an international business. Unless repudiated or clarified, this decision will provide a poor and misguided example for other states to follow until the discriminatory, extraterritorial taxation of foreign income becomes routine. Under such circumstances, this Court should grant review of the decision below and resolve the questions left unanswered in *Mobil*, *Container* and *Kraft*.

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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Dated: January 19, 2000

APPENDIX A

NOTICE: This opinion is subject to motions for rehearing under Rule 22 as well as formal revision before publication in the New Hampshire Reports. Readers are requested to notify the Clerk/Reporter, Supreme Court of New Hampshire, Supreme Court Building, Concord, New Hampshire 03301, of any errors in order that corrections may be made before the opinion goes to press. Opinions are available on the Internet by 9:00 a.m. on the morning of their release. The direct address of the court's home page is: http://www.state.nh.us/courts/supreme.htm

THE SUPREME COURT OF NEW HAMPSHIRE

Merrimack

No. 97-779

CATERPILLAR INC. *et al.*,

v.

NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION *et al.*

October 25, 1999

Rath, Young, and Pignatelli P.A., of Concord (*William F.J. Ardinger* and *Brian T. Tucker* on the brief), *Morrison & Foerster, LLP*, of New York, New York (*Paul H. Frankel* and *Craig B. Fields* on the brief, and *Mr. Frankel* orally), *Sutherland, Asbill & Brennan*, of Washington, D.C. (*Jerome B. Libin* on the brief), and *Daniel J. Schlicksup*, of Peoria, Illinois, by brief, for the plaintiffs.

Philip T. McLaughlin, attorney general (*Martin P. Honigberg*, senior assistant attorney general, on the brief and orally), for the defendants.

Peter S. Garre, of New London, by brief, as *amicus curiae*.

HORTON, J. The plaintiffs, Caterpillar Inc. and two of its subsidiaries, Caterpillar Financial Services Corporation and Solar Turbines Incorporated, appeal a Superior Court (*McGuire, J.*) order granting the cross-motion for summary judgment of the defendants, the State Department of Revenue Administration and its commissioner, in an action challenging the constitutionality of certain provisions of RSA chapter 77-A (1991 & Supp. 1998). We affirm.

Caterpillar Inc. is a multinational corporation headquartered in Peoria, Illinois. In each of the tax years at issue, Caterpillar Inc. owned over fifty domestic and foreign subsidiaries and several foreign affiliates. Caterpillar Inc. and all of its subsidiaries engaged in one unitary business. *See* RSA 77-A:1, XIV. Only the plaintiffs, however, conducted business in New Hampshire and were thus required to file tax returns on their business profits pursuant to RSA chapter 77-A. *See* RSA 77-A:2 (1991) (amended 1993).

In 1991, the State Department of Revenue Administration (department) audited the plaintiffs' 1987, 1988, and 1989 New Hampshire tax returns and issued a notice of assessment, demanding additional business profits tax payments. The department ordered the plaintiffs to remit the taxes due on royalties and interest received by Caterpillar Inc. from various foreign subsidiaries and affiliates from 1987 through 1989, amounts which the plaintiffs had failed to include as income in their returns. The plaintiffs filed a protest with the department in September 1991,

arguing, *inter alia*, that the manner in which the foreign interest and royalty payments had been taxed violated the Commerce Clause of the Federal Constitution, *see* U.S. CONST. art. I, § 8, cl. 3, and requesting an alternate method of apportionment. After a hearing in February 1993, the department rejected the plaintiffs' protest on procedural grounds and declined to decide the constitutional issue based on lack of jurisdiction.

The plaintiffs appealed the department's decision to the superior court. *See* RSA 21-J:28-b, IV (Supp. 1998). The parties filed cross-motions for summary judgment with supporting memoranda. After a hearing, the superior court issued an order in October 1997 granting the defendants' motion for summary judgment. This appeal followed.

The parties have stipulated to the underlying facts and agree that this appeal involves only questions of federal constitutional law. We therefore conduct a *de novo* review of the trial court's decision granting summary judgment in favor of the defendants. *Benoit v. Test Systems*, 142 N.H. 47, 49, 694 A.2d 992, 993 (1997). The heart of this appeal is whether the water's edge apportionment formula in RSA 77-A:3 (1991) (amended 1991, 1993) violates the Commerce Clause by taxing royalty and interest payments received from foreign subsidiaries of a unitary business without subjecting them to global apportionment.

It is well-established that "a State may not tax value earned outside its borders." *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982). When a business operates in more than one jurisdiction, its income must be

apportioned among those jurisdictions and each State must determine its share of the income. *See Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 164, 192 (1983). The Federal Constitution does not impose a particular method upon the States in making this determination. *Id.* at 164.

These principles apply when a business is unitary, that is, comprised of several entities among which there is "substantial mutual interdependence." *Container Corp.*, 463 U.S. at 179 (brackets and quotations omitted). Although there is no universally accepted definition of unitary business, *see id.* at 167-69, for constitutional purposes it is minimally "characterized by a flow of value among its components," *Kraft Gen. Foods, Inc. v. Iowa Dept. of Revenue and Finance*, 505 U.S. 71, 76 (1992). New Hampshire defines unitary business as "one or more related business organizations engaged in business activity both within and without this state among which there exists a unity of ownership, operation, and use; or an interdependence in their functions." RSA 77-A:1, XIV.

"[C]ontributions to income [that] result[ ] from functional integration, centralization of management, and economies of scale," *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980), are difficult to capture on the accounting books when determining total tax liability for a unitary business. *See Container Corp.*, 463 U.S. at 164. Further, transfers of value among entities within a unitary business may mask income earned. *See Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298, 305 (1994). In order to ascertain their just proportion of the profits earned by a unitary business entity within their respective jurisdictions, most States with a corporate income tax

employ formulary apportionment. *See Container Corp.*, 463 U.S. at 164-65. *See generally* Christensen, *Formulary Apportionment: More Simple – On Balance Better?*, 28 Law & Pol'y Int'l Bus. 1133, 1135 (1997).

> Under the apportionment method, the state considers the income generated by all of the corporation's activities, out-of-state as well as in-state, and then apportions a share of such income to the taxing state by means of a formula that compares the taxpayer's in-state activities to all of its activities.

Hellerstein, *State Taxation of Corporate Income From Intangibles: Allied Signal and Beyond*, 48 Tax L. Rev. 739, 745 (1993). At one time, a number of States, *see Barclays Bank PLC*, 512 U.S. at 306, including New Hampshire, calculated taxable income by apportioning the worldwide combined income of the entire unitary group, *see Opinion of the Justices*, 128 N.H. 1, 5, 509 A.2d 734, 737 (1986). Most States using apportionment have now adopted a variant formula, in which the total combined income to be apportioned is confined to the "water's edge" or geographic boundaries of the United States, even though the scope of the unitary business may cross national borders. *See Barclays Bank PLC*, 512 U.S. at 306; *see* RSA 77-A:1, XV, XVI.

New Hampshire's apportionment method operates generally in the following manner: First, the combined net income of the domestic members of the unitary business group is determined (water's edge net income). *See* RSA 77-A:1, XIII,:2-b. Then the three apportionment factors of property, payroll, and sales are calculated to determine the percent of the group's net income attributable to the State for taxation. *See* RSA 77-A:3, I. The property

factor is determined by dividing the value of the taxpayer's New Hampshire real and personal property (the numerator) by the value of the real and personal property of the water's edge group (the denominator). *See* RSA 77-A:3, I(a). The payroll and sales factors are similarly calculated. *See* RSA 77-A:3, I(b), (c). The property, payroll, and sales of the foreign members are not considered in calculating the factors. *See* RSA 77-A:1, XV, XVI. The three resulting percentages are averaged by combining them and dividing the total by three. *See* RSA 77-A:3, II(a). This figure is the apportionment percentage, which is multiplied by the water's edge net income, the product of which is the amount of business profits that New Hampshire may tax. *See generally* RSA 77-A:1, XVI,:2-b,:3.

Royalty and interest payments from one domestic member of the unitary group to another do not change the combined net income of the water's edge group because a receipt to one constitutes a deduction for another. *Cf.* 26 U.S.C.A. §§ 61, 162 (1988). Such payments, however, are eliminated from the combined sales factor (the denominator) to avoid overstating the water's edge sales activity. *See N.H. Tax Form 1120 Specific Instructions For Filing Combined Returns* (1988). This is because the combined sales factor is an aggregate of gross receipts and does not account for deductions.

In contrast, royalty and interest payments from a foreign member of the unitary group to a domestic member are treated as if they were made by unrelated businesses. *See* RSA 77-A:1, VI (defining "gross business income"). The payments are manifested as increases to the net income of the water's edge group and are also

included in the combined sales factor since they constitute a portion of the gross sales receipts of the domestic group. *See* RSA 77-A:1, XIII (defining "combined net income"),:3, I(c). In short, royalty and interest payments of domestic members of a unitary group are subject to apportionment while similar payments by the foreign members to domestic members are taxed without including the foreign property, payroll, and sales in the apportionment factors because their income is excluded from the tax base.

The Commerce Clause of the Federal Constitution provides that "[t]he Congress shall have power to . . . regulate commerce with foreign nations, and among the several states." U.S. CONST. art. I, § 8, cl. 3. It has long been understood as well "to have a 'negative' aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce." *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.*, 511 U.S. 93, 98 (1994). A state tax affecting interstate or foreign commerce violates the Commerce Clause if it: (1) applies to an activity lacking a substantial nexus to the taxing State; (2) is not fairly apportioned; (3) discriminates against interstate commerce; or (4) is not fairly related to the services provided by the State. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). Additionally, a tax affecting foreign commerce must not create an "enhanced risk of multiple taxation," *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 446 (1979), or unduly interfere with the Federal Government's ability to "speak with one voice" in matters of international commerce, *id.* at 449. The plaintiffs argue that New Hampshire's method of combining and

apportioning corporate income facially discriminates against foreign commerce by treating royalty and interest payments received from foreign members of the Caterpillar unitary group less favorably than royalty and interest payments from domestic members.

We first address the State's argument that under *United States v. Salerno*, 481 U.S. 739 (1987), which examined the constitutionality of the Bail Reform Act of 1984 under the Due Process Clause, a party seeking to invalidate a statute on the grounds of facial discrimination must show that there are no circumstances in which the statute would be valid, *Salerno*, 481 U.S. at 745. Even if *Salerno* correctly stated a test for facial challenges, the Supreme Court failed to apply it to a recent facial challenge to Iowa's tax statute, *see Kraft Gen. Foods, Inc.*, 505 U.S. at 72-82, putting into doubt its applicability in this area of law. We therefore decline to apply it in this case. *See Caterpillar, Inc. v. C.I.R.*, 568 N.W.2d 695, 700 n.8 (Minn. 1997), *cert. denied*, 118 S. Ct. 1043 (1998); *Conoco, Inc. v. Taxation & Revenue Dept.*, 931 P.2d 730, 736-37 (N.M. 1996), *cert. denied*, 521 U.S. 1112 (1997).

The party challenging the constitutionality of a state tax bears the burden of proving discrimination. *Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979); *see also Barclays Bank PLC*, 512 U.S. at 310-11. "In order to prove that a state tax statute violates the commerce clause, the taxpayer need not show the extent of disparate tax treatment or demonstrate a minimal level of discriminatory effect; the taxpayer need only prove discrimination against commerce." *Smith v. N.H. Dep't of Revenue Admin.*, 141 N.H. 681, 693, 692 A.2d 486, 495 (1997). We will find discrimination if either the statute's purpose or effect is discriminatory. *Id.*

Characterizing the royalty and interest payments as "repatriations" of the foreign subsidiaries' income, the plaintiffs argue that if the foreign subsidiaries' "income" is included in the calculation of total apportionable income, their property, payroll, and sales factors, which generated such income, must also be included. We disagree.

The royalty and interest payments derive from transactions between the domestic members and foreign members of the Caterpillar unitary group. Caterpillar Inc. and certain other domestic members licensed their trademarks and technology in return for royalty fees and provided loans, payable with interest, to the foreign members. The royalty and interest payments were expenses to the foreign members, deducted on each payor's foreign income tax return. *See Caterpillar Financial Services Corp. v. Whitley*, 680 N.E.2d 1082, 1088 (Ill. App. Ct.), *appeal denied*, 686 N.E.2d 1158 (1997). While perhaps such payments were made from the foreign subsidiaries' income, the payments themselves cannot accurately be characterized as income of the foreign-payors; rather, they constitute income to the domestic recipients and were taxed as such. *See Caterpillar, Inc.*, 568 N.W.2d at 698-99 n.6.

Indeed, royalty and interest payments are usually the result of contractual obligations, independent of the organizational relationship between payor and payee. *See id.* at 699 n.6. The plaintiffs' contention that licensing and borrowing agreements between domestic and foreign entities of a unitary business involve financial considerations absent in agreements between unrelated parties misses the point. The water's edge method purposely

ignores the unitary ties between the foreign and domestic members of a unitary group.

Moreover, "[i]n considering claims of discriminatory taxation under the Commerce Clause . . . it is necessary to compare the taxpayers who are 'most similarly situated.' " *Kraft Gen. Foods, Inc.*, 505 U.S. at 80 n.23. The plaintiffs contend that since it is undisputed that Caterpillar Inc. and all of its domestic and foreign subsidiaries and affiliates operate as a unitary business, the comparison should be between the foreign subsidiaries and the domestic subsidiaries. Although the foreign and domestic entities owned by Caterpillar Inc. may form one unitary business in fact, under the water's edge combined reporting, only the domestic members are treated as a unitary business, the income of which is apportionable and taxable by the State. The foreign members of Caterpillar's unitary group are considered unrelated businesses, whose income is not taxed, transacting at arm's length with members of the water's edge group. *See* RSA 77-A:1, I (1991) (amended 1991, 1993, 1994); *see also Caterpillar, Inc.*, 568 N.W.2d at 697. Hence, the proper comparison is between the foreign members of the unitary group and unrelated domestic entities. *See Caterpillar, Inc.*, 568 N.W.2d at 699.

Royalty and interest payments from foreign members to domestic members of a unitary group, like payments for goods, services, and rents, *see* RSA 77-A:1, VI, are treated as income to the domestic members, as they would be if they were paid by unrelated domestic entities, *compare* RSA 77-A:1, IV ("taxable business profits" includes income from foreign and domestic sources) *with* RSA 77-A:1, XIII ("combined net income" includes

income of only domestic entities). The fact that a water's edge group may owe more tax on royalty and interest payments received from foreign subsidiaries than from domestic subsidiaries, all other things being equal, merely reflects the increase in profits of the water's edge group. The result would be no different if the group had received such payments from unrelated third parties rather than foreign subsidiaries. The water's edge method under RSA chapter 77-A thus treats foreign subsidiaries like similarly situated domestic entities, and no discrimination occurs against the foreign subsidiaries. *See Caterpillar Financial Services Corp.*, 680 N.E.2d at 1088.

We point out that the water's edge method was adopted for the benefit of foreign businesses. Prior to 1986, New Hampshire utilized worldwide combined reporting, in which the net income of all members of the unitary group, domestic and foreign, was included in the tax base. *See Opinion of the Justices*, 128 N.H. at 5, 509 A.2d at 737. In 1986, the legislature adopted the water's edge method, "eliminating overseas business organizations from subjection to [the business profits tax]." Laws 1986, 153:1. Accordingly, while the foreign members' apportionment factors are excluded from the calculation of taxable business profits, their income is exempt from State business profits taxation. Royalty and interest payments by the foreign members to domestic members are included as income of the water's edge group because they "represent value earned by [the water's edge group] that is not otherwise captured." *Du Pont De Nemours v. State Tax Assessor*, 675 A.2d 82, 87-88 (Me. 1996). Like other courts that have considered this issue, we see no constitutional reason why such payments should be

apportioned by a factor that includes the foreign payors' property, payroll, and sales. *See Caterpillar Financial Services Corp.*, 680 N.E.2d at 1088; *Caterpillar, Inc.*, 568 N.W.2d at 701.

The plaintiffs cite a number of cases to support their position that "factor representation is required in the case of the taxation of a unitary business." Although the plaintiffs' cases considered the propriety of factor representation in worldwide combined reporting, *see, e.g., Homart Development Co. v. Norberg*, 529 A.2d 115, 117 (R.I. 1987), or single entity reporting, *see, e.g., Amer. Tel. & Tel. v. Dept. of Revenue*, 422 N.W.2d 629, 633 (Wis. Ct. App.), *review denied*, 422 N.W.2d 629 (1988), they do not address the additional complexities raised by water's edge combined reporting and are unpersuasive in the case before us. *Cf. Du Pont De Nemours*, 675 A.2d at 87-88 (principles governing single entity reporting inapplicable to taxation of foreign dividends under water's edge combined reporting).

The plaintiffs also assert that the dissent in *Mobil Oil Corporation* enunciated a requirement of factor representation in the taxation of unitary businesses that has been adopted by the Supreme Court. *See Mobil Oil*, 495 U.S. at 449-62 (*Stevens*, J., dissenting). *Mobil Oil* concerned the taxation of foreign dividends in the context of single entity formulary apportionment. *See id.* at 441 n.15. The majority declined to address whether the formula itself fairly attributed the dividend income because the taxpayer had not argued it. *Mobil Oil*, 495 U.S. at 434. While the dissent did address the issue, its conclusion that apportionment factors connected to the production of income by the payor corporations should be included in

the apportionment formula was premised on the view that "[e]ither [the taxpayer's] worldwide 'petroleum enterprise' is all part of one unitary business, or it is not; if it is, [the State] must evaluate the entire enterprise in a consistent manner." *Id.* at 461 (citation omitted) (*Stevens*, J., dissenting). Here, there is no dispute that the State consistently evaluated the Caterpillar unitary group, consisting of those members within the water's edge of the United States. Moreover, unlike the jurisdiction in *Mobil Oil*, New Hampshire employs combined reporting; thus, while royalty and interest payments are included in the tax base, they are also added to the denominator of the sales factor, resulting in a proportionate reduction of the sales percentage. *See* RSA 77-A:3, I(c). In its constitutional analysis of *Mobil Oil*, the Supreme Court considered the absence of combined reporting, *see Container Corp.*, 463 U.S. at 168 n.5, and therefore it is questionable whether the Court would apply the same analysis to a combined reporting system as the dissent applied to the formula in *Mobil Oil*. Further, the Court's acknowledgement of the *Mobil Oil* dissent has been limited to unitary taxation in the worldwide combined reporting context. *See id.* We have found no Supreme Court case that approves the broad proposition advocated by the plaintiffs as applied to the facts before us. *Cf. ASARCO Inc.*, 458 U.S. at 326-27 n.22 (application of unitary-business principle is fact-specific).

In sum, we reject the plaintiffs' argument that New Hampshire's apportionment formula unconstitutionally discriminates between foreign and domestic subsidiaries in a unitary business. The nature of the water's edge

formula requires that foreign subsidiaries be treated differently from domestic subsidiaries: most significantly, the latter's income is subject to taxation while the former's income is not. The plaintiffs do not allege that this differential treatment is unconstitutional, yet they seek to avoid the incidental effects that flow from it. They fail, however, to meet their burden in proving discrimination. Although New Hampshire's unitary apportionment formula may not apportion income perfectly, the Federal Constitution does not require "mathematical exactitude," only a "rough approximation." *Illinois Cent. R. Co. v. Minnesota*, 309 U.S. 157, 161 (1940). We are satisfied that requirement is met here.

Affirmed.

All concurred.

APPENDIX B

THE STATE OF NEW HAMPSHIRE

MERRIMACK, SS. **SUPERIOR COURT**

No. 93-E-609

Caterpillar, Inc., et al.

v.

N.H. Dept. of Revenue Administration, et al.

ORDER

Before the Court are Caterpillar, Inc., et al.'s motion for summary judgment and the New Hampshire Department of Revenue Administration, et al.'s (the "Department") cross motion for summary judgment. The petitioners, Caterpillar Inc. and two of its subsidiaries, Caterpillar Financial Services Corporation and Solar Turbines Inc., object to the manner in which the Department calculated their New Hampshire Business Profits Tax, RSA chapter 77-A, for the years 1987-1989. The petitioners claim that certain provisions of this statute facially discriminate against foreign interest and royalty payments in violation of the Commerce Clause of the United States Constitution, Art. I, § 8, cl. 3. The parties have stipulated to the underlying facts and agree that their motions present only issues of Federal constitutional law.

Procedural History

In 1991, the Department conducted an audit of the petitioners' 1987, 1988, and 1989 New Hampshire tax returns. The Department issued a Notice of Assessment, demanding additional Business Profits Tax payments.

The Department ordered payment of the petitioners' apportioned share of $115,072,809, $131,765,387, and $82,417,636 of royalties and $9,270,117, $9,855,844, and 19,555,229 of interest received by Caterpillar from various foreign subsidiaries and affiliates in 1987, 1988, and 1989, respectively. The Department's demand was based an its inclusion of foreign interest and royalty payments as income and the petitioners' failure to do likewise. The petitioners filed a protest with the Department on September 20, 1991, arguing, among things, that the manner in which foreign interest and royalty payments had been taxed violated the foreign Commerce Clause of the United States Constitution. After a hearing held an February 19, 1993, the administrative hearing officer, in an order dated September 29, 1993, rejected petitioner's protest. The hearing officer declined to decide the constitutional issue based on lack of jurisdiction.

The petitioners then filed the present petition pursuant to RSA 21-J:28-b(IV), seeking *de novo* review of the Department's assessment and demand. The petitioners want this court to declare that the method by which their Business Profits Tax was calculated for the years in question violates the foreign Commerce Clause of the United States Constitution. In the summer of 1995, the parties filed cross motions for summary judgment with supporting memoranda. On August 16, 1996, the parties filed a joint motion for interlocutory transfer without ruling pursuant to Supreme Court Rule 9. The New Hampshire Supreme Court declined interlocutory transfer on January 31, 1997. Pursuant to a March 24, 1997 scheduling order,

the parties filed new cross motions for summary judgment with supporting memoranda. The Court held a hearing on the parties' summary judgment motions on August 14, 1997.

Background

Caterpillar, Inc. is the parent of numerous domestic and foreign subsidiaries and several foreign affiliates. Caterpillar and all of its subsidiaries engage in one unitary business.[1] Caterpillar, Inc. and two of its domestic subsidiaries, Caterpillar Financial Services Corporation and Solar Turbines Incorporated, the petitioners in this case, conduct business in New Hampshire and are thus required to pay New Hampshire Business Profits Tax (RSA chapter 77-A). Each of these three corporations also does business outside New Hampshire. No state may tax income earned outside its borders. Therefore, New Hampshire's share of the income of these three corporations must be determined by means of apportionment. *Container Corp. of America v. Franchise Tax Bd.*, 103 S.Ct. 2933 (1983).[2]

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[1] " 'Unitary Business' means one or more related business organizations engaged in business activity both within and without this state among which there exists a unity of ownership, operation, and use; or an interdependence in their functions." RSA 77-A:1(XIV). A unitary business group is comprised of separately incorporated entities involved in a single line of business. *United States Steel Corp. v. Multistate Tax Commission*, 98 S.Ct. 799, 813 (1978).

[2] "The linchpin of apportionability is the unitary business concept." *Mobil Oil Corp.*, 100 S.Ct. at 1232. Apportionment has been generally described as a calculation of the local tax base by

New Hampshire has adopted the "water's edge" method, RSA 77-A:1(XVI), to determine the portion of Caterpillar's unitary business income subject to tax in this state.[3] Using the water's edge method, the petitioners' New Hampshire Business Profits Tax is calculated generally in the following manner.

First, the total business income of the domestic members of the Caterpillar unitary business group is

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defining the scope of the unitary business and apportioning the total income of the business between the taxing state and the rest of the world using a formula that considers the unitary business's activities within and without the taxing state. *Container Corp. of America*, 103 S.Ct. at 2940. Unitary business apportionment has been repeatedly upheld by the Federal Supreme Court. *See id.* "Functional integration, economies of scale, and centralization of management" typically render efforts to isolate income earned by a unitary group in a particular state futile because profitability arises from operation of the business as a whole. *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 100 S.Ct. 1223, 1232 (1980).

[3] The State faces inherent difficulties in apportioning its share of the taxable income of unitary business groups operating in New Hampshire. In light of the "elusive" nature of this task, the Federal Constitution imposes no single apportionment formula on the States. *Container Corp.*, 103 S.Ct. at 2939. No allocation method will enable the State to determine precisely the amount of income attributable to a group's New Hampshire operations, and every formula "devised involves some degree of arbitrariness." *Barclays Bank v. Franchise Tax Bd. of California*, 114 S.Ct. at 2268, 2272 (1994). New Hampshire's formula is intended to yield a "fair and equitable" approximation of taxable income. *Pandora Indus., Inc. v. State Dep't of Revenue Admin.*, 118 N.H. 891, 895 (1978).

determined.[4] Next, the Department calculates the three apportionment factors of property, payroll, and sales to determine the percent of the group's total income allowable to the State for business profits taxation. This three-factor formula is widely used by other states and has passed constitutional scrutiny. *See Butler Bros., Inc. v. McColgan,* 62 S.Ct. 701 (1942).

The property factor is determined by dividing the value of the petitioners' New Hampshire real and personal property (the numerator) by the value of the real and personal property of the water's edge group (the denominator).[5] The payroll and sales factors are determined in like fashion. The three resulting percentages are then averaged by combining them and dividing the total by three. This figure is the apportionment percentage which is multiplied by the water's edge group's total income, the sum being the amount of business profits that New Hampshire may tax. The New Hampshire tax rate is applied to determine the amount of the tax. *See generally* RSA 77-A:2, 3.

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[4] In this respect, the water's edge reporting method differs from the worldwide reporting method. Under the worldwide apportionment formula, the taxable income base is determined by combining the income of the entire unitary business group including both domestic and foreign subsidiaries. *Barclays Bank v. Franchise Tax Bd. of California,* 114 S.Ct. 2268, 2273 (1994).

[5] If the worldwide reporting method were employed, the property, payroll, and sales apportionment factors would he determined by dividing the unitary group's New Hampshire property, payroll, and sales income by the unitary group's worldwide property, payroll, and sales income. *Barclays,* 114 S.Ct. at 2273.

Interest and royalty payments by a foreign member of the unitary business to a domestic member are included in the income base. Interest and royalty payments made between members of the water's edge group are included in the income base because, although not added to the income of the payor, they are also not deducted from the income of the payee.

The income of foreign entities in a unitary group is not included in water's edge combined reporting, *see* RSA 77-A:1 (XV), (XIX). The Department, therefore, does not consider the apportionment factors of the foreign entities in determining what percentage of the water's edge group's income may be apportioned to New Hampshire for business profits taxation.

Discussion

The Commerce Clause provides that Congress may "regulate Commerce with foreign Nations, and among the several States." U.S. Const. Art. I, § 8, cl. 3. Although the Commerce Clause addresses Congress' right to regulate commerce, the Clause "has long been understood, as well, to provide protection from state legislation inimical to the national commerce [even] where Congress has not acted. . . . " *Barclays Bank v. Franchise Tax Bd. of California*, 114 S.Ct. 2268, 2276 (1994). State taxation of business income runs afoul of the Commerce Clause if

> the taxpayer demonstrates that the tax either (1) applies to an activity lacking a substantial nexus to the taxing State; (2) is not fairly apportioned; (3) discriminates against interstate [or foreign] commerce; or (4) is not fairly related to the services provided by the State.

Id. (citing *Complete Auto Transit, Inc. v. Brady,* 97 S.Ct. 1076, 1079 (1977). The taxing scheme must be considered in light of its actual effect and in conjunction with its other provisions. *Maryland v. Louisiana,* 101 S.Ct. 2114, 2134 (1981).

The petitioners base their constitutional challenge on prong three, arguing that New Hampshire's method of combining and apportioning corporate income facially discriminates against foreign commerce by treating interest and royalty payments from foreign members of the Caterpillar unitary group less favorably than interest and royalty payments received from domestic members. Specifically, the petitioners claim that including foreign interest and royalty payments in the taxable income base of the water's edge corporations without including the property, payroll, and sales factors of the foreign entities in the denominator of the apportionment fraction discriminates against foreign commerce. The petitioners contend that such a method always results in a greater apportionment percentage to be applied to income and in higher taxes payable for foreign interest and royalty payments than for domestic interest and royalty payments.

In advancing their claim of discriminatory taxation, the petitioners rely solely on *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance,* 112 S.Ct. 2365 (1992). The State responds that the Iowa taxation statute declared unconstitutional in *Kraft* is distinguishable from the New Hampshire tax scheme, RSA chapter 77-A.[6]

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[6] The respondents have attempted to distinguish *Kraft, inter alia,* on the ground that foreign dividend taxation was

The Iowa taxation statute in *Kraft* called for separate or single entity reporting.

> Pursuant to single entity reporting only the values of a single business's activities within the state are reflected in the taxpayer's tax base. The taxing authority carves out from the taxpayer's overall business those activities taking place in, the property employed in, and the income derived from sources within a single state to determine the income attributable to the state. The various subsidiaries of a multijurisdictional enterprise are viewed as separate from one another and the income of the affiliates that do not do business in the state are not considered in the income of the "single entity."

Du Pont De Nemours v. State Tax Assessor, 675 A.2d 82, 87 n. 9 (citing Hellerstein & Hellerstein, *State and Local Taxation* 432 (4th ed. 1978)).

In contrast, under New Hampshire's combined water's edge reporting, the tax base includes the income of all domestic members of the unitary business group, whether those corporations do business in New Hampshire or not. New Hampshire, however, apportions only part of this combined income base by applying a formula that takes into account the extent to which members of the water's edge group do business in the state. *See Du Pont*, 675 A.2d at 87.

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challenged in *Kraft* while the taxation of foreign royalty and interest payments is at issue in this case. The Court does not reach this issue because it distinguishes *Kraft* on other grounds.

The Iowa single entity reporting method taxed only those members of a unitary business group actually operating within the state. Domestic subsidiaries not conducting business in Iowa were, therefore, excluded from the tax base as were foreign subsidiaries. However, dividends paid to the reporting parent corporation by domestic subsidiaries were excluded from the income base while dividends paid by foreign subsidiaries were included and thus subject to taxation. *Kraft,* 112 S.Ct. at 2368 n. 10. The Court found that domestic and foreign subsidiaries not doing business in Iowa were similarly situated pursuant to its single entity reporting system. Iowa could offer no satisfactory reason for taxing foreign dividends, and not domestic dividends, where both were paid to the parent corporation by subsidiaries situated similarly under the single entity reporting method.

Kraft itself states that the outcome would have been different had Iowa employed a combined apportionment method. 112 S.Ct. at 2371 n. 23.[7] Every case considering

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[7] *Kraft's* footnote 23 states,

> If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent. *In considering claims of discriminatory taxation under the Commerce Clause,*

Kraft, whether in the context of dividends or interest and royalty payments, has limited *Kraft's* holding to cases involving single entity reporting regimes. *See Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993); *E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996); *Caterpillar Financial Services Corp. v. Whitley*, et al., No. 3-94-0830 (Ill. Ct. App., May 19, 1997); *Caterpillar, Inc. v. Commissioner of Revenue*, No. 6633 (Minn. Tax Ct. November 14, 1996); *see also Conoco, Inc. v. Taxation and Revenue Dept.*, 931 P.2d 730 (N.M. 1996) (holding *Kraft* applicable under New Mexico's single entity reporting scheme); *Dart Indus. v. Clark*, 657 A.2d 1062 (R.I. 1995) (holding *Kraft* applicable under Rhode Island's single entity reporting scheme).

In this case, unlike the situation in *Kraft*, the interest and royalty payments made by domestic and foreign subsidiaries are not treated differently. They are both included in the income base of the water's edge group. *See* Memorandum in Support of Petitioners' Motion for Summary Judgment at 15. They are subjected to the same apportionment formula and taxed at the same rate.

> *however, it is necessary to compare the taxpayers who are, "most similarly situated."* A corporation with a subsidiary doing business in Iowa is not situated similarly to a corporation with a subsidiary doing business abroad. In the former case, the Iowa operations of the subsidiary provide an independent basis for taxation not present in the case of the foreign subsidiary. A more appropriate comparison is between corporations whose subsidiaries do not do business in Iowa.

Kraft, 112 S.Ct. at 2371 (citation omitted) (emphasis added).

Any differing treatment of domestic and foreign subsidiaries as a whole results not from unconstitutional discrimination but from the fact that they simply are not similarly situated. Under the water's edge apportionment formula, all of the income of domestic subsidiaries is included in the income base. The domestic apportionment factors must be included to apportion that income. The income of foreign subsidiaries is excluded entirely from the group's income. Accordingly, their apportionment factors are also excluded.

What petitioners complain about, the lack of inclusion of the foreign subsidiaries' property, payroll, and sales factors in the denominator of the apportionment factor, is really a challenge to the water's edge method of combined reporting. As previously noted, this method of apportionment has been found constitutional and is used in many states. The only fair way to include all of the property, payroll, and sales factors of foreign subsidiaries in the apportionment denominator would be to adopt a worldwide combination reporting regime which is not mandated nor even considered advisable by many experts.[8]

The same issue raised by the petitioners was addressed in *Caterpillar Financial Services Corp. v. Whitley,*

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[8] Although constitutional, the use of worldwide apportionment has generated considerable controversy. "The governments of many of our [nation's] trading partners have expressed their strong disapproval of [the worldwide] method of taxation." *Barclays,* 114 S.Ct. at 2283 n. 22. Numerous states have responded by restricting their worldwide apportionment methods or switching to a water's edge approach. *See* 1 Hellerstein and Hellerstein, *State Taxation* ¶ 8.16 at 8-185, 8-187.

et al., No. 3-94-0830 (Ill. Ct. App., May 19, 1997), and *Caterpillar, Inc. v. Commissioner of Revenue*, No. 6633 (Minn. Tax Ct. November 14, 1996). The courts in both decisions rejected the arguments advanced by the petitioners. The *Whitley* court concluded that the Illinois water's edge method of apportionment did not facially discriminate against foreign commerce because only royalty and interest payments of foreign subsidiaries were taxed. Domestic subsidiaries, although not taxed on royalty and interest payments, were taxed on their income. The lack of "taxing symmetry" fatal to the Iowa scheme in *Kraft* was not present in the Illinois taxation statute. *Whitley*, slip op. at 15.[9] In *Caterpillar, Inc. v. Commissioner of Revenue*, No. 6633 (Minn. Tax Ct. November 14, 1996), the Minnesota Tax Court held that interest and royalty payments from foreign subsidiaries may be treated differently than the same payments from domestic subsidiaries because, as a result of the exclusion of foreign subsidiaries from water's edge combined reporting, foreign and domestic subsidiary groups were not similarly situated.

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[9] In *Whitley*, the Illinois Court of Appeals concurred with the Supreme Courts of Kansas and Maine, both of which, on the basis of footnote 23 in *Kraft*, limited the application of that case "to states that do not use a combined water's edge or domestic reporting method, but instead employ a single entity method of reporting." *Whitley*, slip op. at 13-15 (citing *Appeal of Morton Thiokol, Inc.*, 864 P.2d at 1186 (holding that foreign subsidiaries were not discriminated against because their total income was not subject to taxation, only dividend payments to the parent were taxed; domestic subsidiaries, although not taxed on dividends, were taxed on their total income); *DuPont*, 675 A.2d at 88-89 (holding same).

For the above reasons, the Court finds that New Hampshire water's edge method of business profits taxation does not violate the Commerce Clause of the Federal Constitution. Accordingly, the petitioners' Motion for Summary Judgment is **DENIED** and the respondents' Cross-Motion for Summary Judgment is **GRANTED**.

So ORDERED.

Date: 10/10/97

/s/ Kathleen A. McGuire
Kathleen A. McGuire
Presiding Justice

APPENDIX C

THE STATE OF NEW HAMPSHIRE

SUPREME COURT

In Case No. 96-812, *Caterpillar Inc. & a. v. NH Department of Revenue Administration & a.*, the court upon January 31, 1997, made the following order:

Joint motion for filing of "interlocutory transfer without ruling statement" more than ten days after signing by the superior court is granted. Interlocutory transfer without ruling is declined. *See* Rule 9(1).

Distribution:

Jerome B. Libin, Esquire
Steven M. Sobell, Esquire
Martin P. Honigberg, Esquire
Mark P. Szpak, Esquire
Daniel J. Schlicksup, Esquire
Clerk, Merrimack County Superior Court 93-E-609-B
Honorable George L. Manias
Donna K. Nadeau, Supreme Court
File

Howard J. Zibel,
Clerk

APPENDIX D

96-812

IN THE STATE OF NEW HAMPSHIRE

MERRIMACK, SS. AUGUST TERM, 1996

SUPERIOR COURT

93-E-609-B

CATERPILLAR INC., *ET AL.*,

Petitioners,

v.

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION AND STANLEY R. ARNOLD, JR., THE NEW HAMPSHIRE COMMISSIONER OF REVENUE

Respondents.

INTERLOCUTORY TRANSFER WITHOUT RULING STATEMENT

A. Statement of Facts

During the tax years at issue (1987-1989), Caterpillar Inc. and its domestic and foreign subsidiaries and foreign affiliates (the "Caterpillar Unitary Group") were engaged in one unitary business. (Stip ¶1) Caterpillar Inc. and two of its domestic subsidiaries, Caterpillar Financial Services Corporation and Solar Turbines Incorporated (hereinafter, "Petitioners"), conducted business in New Hampshire during those years. (Stip ¶7)

Under the New Hampshire water's edge combined reporting system, the federal taxable incomes (before net

operating losses and other special deductions) of each of the domestic members of the unitary group are combined to produce "Combined Net Income." (Stip ¶17). Combined Net Income is then apportioned to New Hampshire based on a formula that reflects the ratio of the New Hampshire property, payroll and sales to the total property, payroll and sales of the water's edge group. (Stip. ¶17)

Caterpillar Inc. and certain other domestic members licensed their trademarks and technology in return for royalty payments, and provided intercompany loans, to foreign and domestic members of the Caterpillar Unitary Group. (Stip. ¶10)

All intercompany payments received by a domestic member of the group from other domestic members (including interest and royalty payments, if any) are eliminated in calculating Combined Net Income. Interest and royalty payments received by a domestic member from foreign members of the group are not eliminated from the recipient's income. (Stip ¶17)

The Petitioners' position is that the New Hampshire water's edge combined reporting method of taxation for a unitary business group that includes both domestic and foreign members facially discriminates against foreign commerce in violation of the Foreign Commerce Clause of the United States Constitution by taxing interest and royalty payments received from foreign members of a unitary group less favorably than interest and royalty payments received from domestic members of the unitary group.

The Respondent's position is that, for Business Profits Tax purposes, the relevant combined group is the Water's Edge Group and that interest and royalty income

received from foreign unitary members (or unrelated third parties) that are not part of the water's edge combined group is taxable through the water's edge apportionment factors. Excluding the factors of affiliated companies that are not part of the Water's Edge Group is no different from excluding the factors of unrelated payors of interest or royalties. The statute thus does not discriminate against foreign commerce.

B. Statement of Questions Presented

1. Whether the New Hampshire water's edge combined reporting system's treatment of interest and royalty payments made by foreign members of the Caterpillar Unitary Group to Caterpillar Inc. constitutes facial discrimination against foreign commerce in violation of the Foreign Commerce Clause of the United States Constitution?

2. Whether Petitioners, in order to establish their facial discrimination claim, must prove that the New Hampshire water's edge apportionment formula caused a "gross distortion" in the amount of their income that was attributed to New Hampshire?

C. Statement of Reasons Why Interlocutory Transfer is Appropriate Under Supreme Court Rule 9

1. Substantial Basis for Disagreement

This case presents issues of first impression in New Hampshire. Although several cases arising in other states have touched on these issues, Petitioners and Respondent disagree as to how such cases apply to the instant case.

Accordingly, a substantial basis exists for a difference of opinion as to the issues presented.

2. **Interlocutory Transfer Will Materially Advance the Disposition of the Litigation and Will Decide Issues of General Importance in the Administration of Justice**

Resolution of the issues in this case by the New Hampshire Supreme Court on an interlocutory basis without ruling is appropriate because the New Hampshire Supreme Court will ultimately have to resolve these questions of law. The parties have stipulated to the facts of this case, and, accordingly, the New Hampshire Supreme Court need only rule on the legal issues presented.

The issues presented call into question the constitutionality of one of the State's sources of revenue and are, therefore, fundamentally questions of general importance in the financial administration of the State and in the administration of justice. This is an important constitutional case that presents pure questions of law regarding the application of the Foreign Commerce Clause of the U.S. Constitution to the New Hampshire water's edge combined reporting system.

D. Attached are the Following Relevant Statutory and Constitutional Provisions

1. U.S. Constitution, Article I, § 8, cl.3
2. RSA 77-A:1 (1995)
3. RSA 77-A:3 (1995)

4. New Hampshire Tax Return – Form NH 1120 Instructions

E. Counsel for the Parties are as follows:

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DATED: 8/12/96 /s/ G. Manias
Presiding Justice

Appendices

Appendix 1 U.S. Constitution, Article I, § 8, cl. 3

Appendix 2 RSA 77-A:1 (1995)

Appendix 3 RSA 77-A:3 (1995)

Appendix 4 New Hampshire Tax Return – Form NH 1120 Instructions

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Appendix 1

Section 8, Clause 3. Regulation of Commerce

To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

Appendix 2 [*]

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TITLE V. TAXATION

CHAPTER 77-A. BUSINESS PROFITS TAX

RSA 77-A:1 (1995)

STATUS: CONSULT SLIP LAWS CITED BELOW FOR
RECENT CHANGES TO THIS DOCUMENT
<=A1> LEXSEE 1996 NH ALS 154 – See section 1.

77-A:1. Definitions

When appearing in this chapter:

I. "Business organization" means any enterprise, whether corporation, partnership, limited liability company, proprietorship, association, business trust, real estate trust or other form of organization; organized for

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[*Petitioners note that the statutes (N.H. Rev. Stat. Ann. §§ 77-A:1, 77-A:3) in effect for the years at issue (1987-1989), which were amended over the years in minor respects having no bearing upon the controversy before this Court, are substantially similar to the statutes attached as Appendices 2 and 3 by the Superior Court to its Interlocutory Transfer Without Ruling Statement and reproduced herein. It is noted that, in computing the apportionment fraction, the sales factor currently has a 1.5-weighting, was double-weighted for a period of time, and was single-weighted during the years at issue.]

gain or profit, carrying on any business activity within the state, except such enterprises as are expressly made exempt from income taxation under the United States Internal Revenue Code as defined in RSA 77-A:1, XX. Each enterprise under this definition shall be subject to taxation under RSA 77-A:2 as a separate entity, unless specifically authorized by this chapter to be treated otherwise, such as, but not limited to, combined reporting. Trusts treated as grantor trusts under section 671 of the United States Internal Revenue Code shall be included in the return of their owners, and such owners shall be subject to the tax thereon to the extent such owners would be considered a business organization hereunder notwithstanding the existence of the trust. The use of consolidated returns as defined in the United States Internal Revenue Code as defined in RSA 77-A:1, XX is not permitted. Notwithstanding any other provision of this paragraph, an enterprise shall not be characterized as a business organization and shall be excluded from taxation at the entity level if it is a qualified investment company as defined in RSA 77-A:1, XXI that is not taxable under RSA 77-A:2-c. A partnership, limited liability company, estate, trust except grantor trusts pursuant to section 671 of the United States Internal Revenue Code, "S" corporation, real estate investment trust, or any other such entity, other than a qualified investment company as defined in RSA 77-A:1, XXI that is not taxable under RSA 77-A:2-c, whose net income is reportable by the true owners either directly or indirectly shall be subject to tax at the entity level, and no part of such earnings or loss shall be included in the calculation of the gross business profits of the owners of such entity.

II. "Commissioner" means the commissioner of revenue administration.

III. "Gross business profits" means:

(a) In the case of a corporation, except "S" corporations, or any other business organization required to make and file a United States corporation income tax return, or in the case of a corporation which does not make and file a separate United States corporation income tax return for itself because it is a member of an affiliated group pursuant to the provisions of chapter 6 of the United States Internal Revenue Code as defined in RSA 77-A:1, XX, the amount of taxable income as would be determinable under the provisions of the United States Internal Revenue Code as defined in RSA 77-A:1, XX before the application of any net operating loss deduction, special deductions shown on line 29 of the federal corporate income tax return, or any other special deductions allowable only to a certain class of corporate taxpayer.

(b) In the case of "S" corporations or any other business organizations required to make and file an "S" corporation return, the net profit from all business activity determined in accordance with rules adopted by the department of revenue administration under RSA 541-A.

(c) In the case of a partnership or any other business organization required to make and file a United States partnership return of income, the amount of ordinary income as would be determinable under the provisions of the United States Internal Revenue Code as defined in RSA 77-A:1, XX increased by the amounts shown as payments to partners on the federal partnership

return of income, the net amount of any gains from the sale of partnership assets, items of income specifically allocated to partners and decreased by any deductions specifically allocated to partners or losses on the sale of partnership assets.

(d) In the case of a proprietorship, the amount of net profit or loss from a business, profession, rental, or farming activities as would be determinable under the provisions of the United States Internal Revenue Code as defined in RSA 77-A:1, XX adjusted by the amount of any gains or losses from the sale of assets held or used in business activity.

(e) In the case of a trust, estate, or any other business organization engaging in business activity, the amount of net profit from such business activity and the net amount of any gains from the sale of assets held for use in business activity.

(f) In the case of any business organization which is part of a water's edge combined group and which does not make or file a United States income tax return or schedule under subparagraphs (a)-(d), the amount of net income as would be determinable under the provisions of the United States Internal Revenue Code as defined in RSA 77-A:1, XX and applied within the concepts of RSA 77-A for such business organizations.

IV. "Taxable business profits" means gross business profits adjusted by the additions and deductions provided in RSA 77-A:4 and then adjusted by the method of apportionment provided in RSA 77-A:3.

V. "Taxable period" means the calendar year or fiscal year which the taxpayer uses for United States income tax purposes, or that part of a year for which a return is made.

VI. "Gross business income" means all income for federal income tax purposes from whatever source derived in the conduct of business activity, including but not limited to gross proceeds from sales, compensation for rendering services, gross proceeds realized from trading in stocks, bonds, or other evidences of indebtedness, gross proceeds realized from sale of assets used in trade or business, interest, discount, gross rents, royalties, fees, commissions, dividends, without any deduction on account of the cost of property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense paid or accrued and without any deduction on account of losses.

VII. "Prescribed Filing Date" means the original statutory due date, or approved extended due date.

VIII. "Prescribed Payment Date" means the original statutory due date.

IX. "Qualified charitable contributions" means a charitable contribution of tangible personal property as defined in section 1221(1) of the United States Internal Revenue Code as defined in RSA 77-A:1, XX, but only if all of the following conditions are met:

(a) The contribution is either to an educational organization which is described in section 170(b)(1)(A)(ii) of the United States Internal Revenue Code as defined in RSA 77-A:1, XX or to an institution of higher education as

defined in section 3304(f) of the United States Internal Revenue Code as defined in RSA 77-A:1, XX or to both an educational organization and an institution of higher education as defined in this subparagraph.

(b) The contribution is made not later than one year after the date the manufacture or purchase of the property is substantially completed.

(c) The original use of the property is by the donee.

(d) The property is a computer, scientific equipment, or apparatus, all of the use of which by the donee is directly for the education of students in the state of New Hampshire.

(e) The property is not transferred by the donee in exchange for money, other property, or services.

(f) The taxpayer receives from the donee a written statement representing that its use and disposition of the property shall be in accordance with these provisions.

(g) The contribution is made between July 1, 1983, and June 30, 1984.

X. "Qualified research contribution" means a charitable contribution by a taxpayer of tangible personal property as defined in section 1221(1) of the United States Internal Revenue Code as defined in RSA 77-A:1, XX, but only if all of the following conditions are met:

(a) The contribution is either to an educational organization which is described in section 170(b)(1)(A)(ii) of the United States Internal Revenue Code as defined in RSA 77-A:1, XX or to an institution of higher education as defined in section 3304(f) of the United States Internal

Revenue Code as defined in RSA 77-A:1, XX or to both an educational organization and an institution of higher education as defined in this subparagraph.

(b) The contribution is made not later than 2 years after the date the manufacture or purchase of the property is substantially completed.

(c) The original use of the property is by the donee.

(d) The property is scientific equipment or apparatus, substantially all of the use of which by the donee is for research or experimentation, or for research training in physical or biological sciences for students.

(e) The property is not transferred by the donee in exchange for money, other property, or services.

(f) The taxpayer receives from the donee a written statement representing that its use and disposition of the property shall be in accordance with these provisions.

(g) For all tax years beginning after December 31, 1992, the United States Internal Revenue Code of 1986, in effect on August 10, 1993.

XI. "Business asset" means any tangible or intangible property, whether real or personal, previously used, currently used, or available for use in any business activity.

XII. "Business activity" means a group of actions performed by a business organization for the purpose of earning income or profit from such actions and includes every operation which forms a part of, or a step in, the process of earning income or profit from such group of

actions. The actions ordinarily include, but are not limited to, the receipt of money, property, or other items of value and the incurring or payment of expenses. Notwithstanding any other provision of this paragraph, a holder of an ownership interest in a qualified investment company as defined in RSA 77-A:1, XXI, shall not be deemed to be carrying on any business activity within this state due solely to its holding an ownership interest in such qualified investment company.

XIII. "Combined net income" means the revenues less expenses as would be determinable under the provisions of the Internal Revenue Code as defined in RSA 77-A:1, XX and applied within the concepts of RSA 77-A for all business organizations conducting a unitary business regardless of whether such business organizations are required to file a federal income tax return.

XIV. "Unitary business" means one or more related business organizations engaged in business activity both within and without this state among which there exists a unity of ownership, operation, and use; or an interdependence in their functions.

XV. "Water's edge combined group" means a group of business organizations as defined in RSA 77-A:1, I operating a unitary business, except for overseas business organizations, as defined in paragraph XIX; provided, however, overseas business organizations shall only be excluded from the definition of "water's edge combined group" if the following criteria are met:

(a) The taxpayer certifies that transactions conducted between such business organizations and other members of the group are on a comparable basis to

transactions between other business organizations owned or controlled by the taxpayer and any members of the water's edge combined group; and

(b) The taxpayer agrees to report to the commissioner any adjustments as finally determined by the United States Internal Revenue Service with respect to such transactions between any related business organizations as may have a bearing on the comparability of transactions referred to in subparagraph (a). These adjustments shall be made to the 80/20 business organizations so that a comparable basis shall be maintained for New Hampshire tax purposes. Such report shall be made in the manner and within the time limits as provided in RSA 77-A:10. Nothing in this paragraph shall exclude from taxation any business organization carrying on business activity within the state.

XVI. "Water's edge method" means the determination of taxable business profits for a group of business organizations conducting a unitary business by adding their combined net income, the additions and deductions provided in RSA 77-A:4 for the members of the group, and apportioning the result as provided in RSA 77-A:3.

XVII. "Foreign dividends" as used in RSA 77-A:3, II means dividend income received from affiliated business organizations, which have 80 percent or more of the average of their payroll and property assignable to a location outside the 50 states and the District of Columbia.

XVIII. "Foreign property, payroll and sales" as used in RSA 77-A:3, II means the property, payroll and sales data of affiliated business organizations which have 80

percent or more of the average of their payroll and property assignable to a location outside the 50 states and the District of Columbia, and which have paid dividends to a member of the water's edge combined group.

XIX. "Overseas business organizations" means business organizations with 80 percent or more of the average of their payroll and property assignable to a location outside the 50 states and the District of Columbia.

XX. "United States Internal Revenue Code" means:

(a) The United States Internal Revenue Code without the rules, regulations, forms, and procedures of the United States Internal Revenue Service. The rules, regulations, forms and procedures of the United States Internal Revenue Service may, however, be used by the commissioner of revenue administration in formulating rules for adoption under RSA 541-A. This definition shall be operative unless and until a specific statutory exception to its adoption is provided in this chapter, or until the application of one of its provisions is held to violate the New Hampshire constitution.

(b) For all tax years beginning before January 1, 1987, the United States Internal Revenue Code (1954) as amended.

(c) For all tax years beginning after December 31, 1986, the United States Internal Revenue Code of 1986 in effect on December 22, 1987.

(d) For all tax years beginning after December 31, 1987, the United States Internal Revenue Code of 1986 in effect on November 10, 1988.

(e) For all tax years beginning after December 31, 1988, the United States Internal Revenue Code of 1986 in effect on December 19, 1989.

(f) For all tax years beginning after December 31, 1990, the United States Internal Revenue Code of 1986 in effect on November 5, 1990.

(g) For all tax years beginning after December 31, 1992, the United States Internal Revenue Code of 1986, in effect on August 10, 1993.

(h) For all tax years beginning after December 31, 1994, the United States Internal Revenue Code of 1986, in effect on December 31, 1994.

XXI. "Qualified investment company" means a regulated investment company as defined in section 851 of the United States Internal Revenue Code as defined in RSA 77-A:1, XX, an organization that is an investment company under the Investment Company Act of 1940 as amended, or an organization that would be an investment company under the Investment Company Act of 1940, as amended, except for the exemption provided by section 3(c)(1) of said Investment Company Act, provided, however, a qualified investment company shall limit its activities to investment activities and those incidental to or in support of such activities and shall submit certification that it satisfies the requirements to be classified as a qualified investment company to the commissioner no later than 9 months subsequent to commencement of its investment activities. Upon petition, the commissioner may accept an untimely submission of such certification, which acceptance shall not be unreasonably withheld.

XXII. "Compensation", for the purposes of RSA 77-A:5, VII, means all wages, salaries, fees, bonuses, commissions, or other items, including the following employee benefits: health, life and disability insurance and pensions, profit sharing and retirement benefits.

XXIII. "Eligible employee" means any individual employed by a business organization who, as of the last day of the applicable tax year:

(a) Has been employed by such business organization for at least 6 consecutive months;

(b) Has not been an eligible employee of such business organization or a substantially similar predecessor business organization for any prior taxable year; and

(c) Performs all but an incidental portion of services at a location or locations within the state. For the first taxable year in which the job creation tax credit allowed under RSA 77-A:5,VII, is effective, no employees employed on the first day of such taxable year shall be treated as eligible employees of such business organization for such first taxable year or any succeeding taxable year. For purposes of this paragraph, the commissioner is authorized to adopt rules pursuant to RSA 541-A to define the terms "substantially similar predecessor business organization" and "incidental portion of services."

XXIII-a. "Limited liability company" means a limited liability company formed under RSA 304-C or a foreign limited liability company as defined in RSA 304-C:1, IV. In the case of a limited liability company required to make and file a United States partnership return of income, the provisions of this chapter shall be applied as

though the limited liability company were a partnership and its members were partners.

XXIV. "Qualifying venture capital fund" means any investment company, partnership, or other organization that notifies the commissioner, on a form to be prescribed by the commissioner, that it desires to be treated as a qualifying venture capital fund for purposes of this chapter and certifies by sworn statement under the pains and penalties of perjury that it meets the following conditions:

(a) It is organized under the laws of New Hampshire;

(b) It is not an affiliate of a bank;

(c) It intends to hold at least 95 percent of its total assets, measured on the last day of the applicable tax period, in one or more qualifying venture capital investments;

(d) Its New Hampshire apportionment percentage is at least 80 percent; and

(e) It qualifies as a qualified investment company under RSA 77-A:1, XXI.

XXV. "Qualifying venture capital investment" means capital made available to a qualifying start-up firm through equity or debt instruments, and capital previously provided a qualifying start-up firm that is no longer a qualifying start-up firm for reasons other than its failure to remain taxable under this chapter, its failure to retain New Hampshire as its headquarters and principal place of business, or its failure to continue to meet the

criteria in RSA 77-A:1, XXVI for qualification as a qualifying start-up firm for 3 years from the initial date of such qualification.

XXVI. "Qualifying start-up firm" means a business organization which meets all the following criteria:

(a) The business organization is organized under the laws of New Hampshire.

(b) The business organization is subject to taxation under RSA 77-A.

(c) The apportionment of the business organization's gross business profits pursuant to RSA 77-A:3 results in at least 80 percent of such profits being taxable in New Hampshire.

(d) At least 80 percent of the proprietors, partners, officers, and employees of the business organization reside in New Hampshire.

(e) The business organization is not an affiliate of any business organization or affiliated group of business organizations that, based on filings made for the 3 previous taxable periods, had an average taxable period tax liability pursuant to RSA 77-A of more than $250,000.

(f) The business organization is not an affiliate of any business organization or affiliated group of business organizations of any non-qualifying start-up firm that has contributed more than 25 percent of the capital contributions to a qualifying venture capital fund, which fund has, during the period of such contributions, provided capital to the business organization asserting status as a qualifying start-up firm.

(g) The business organization certifies by sworn statement under the pains and penalties of perjury to the commissioner that the business organization will retain New Hampshire as its headquarters and principal place of business for at least 10 years from the receipt of any capital from any qualifying venture capital fund. Such certification shall be on a form prescribed by the commissioner and is to be regarded as a contract between the state and the business organization, its successors and assigns.

XXVII. "Affiliate", for the purposes of RSA 77-A:1, XXIV and XXVI means an entity or business organization that is affiliated with one or more other business organizations or entities.

XXVIII. "Affiliated", for the purposes of RSA 77-A:1, XXVI and XXVII, means any entity or business organization that controls, or is controlled by, or under common control with, another entity or business organization. For purposes of this definition, the term "control" means the ownership or holding, with power to vote, of 25 percent or more of the total combined voting securities of an entity or business organization. The commissioner may also determine the existence of control for purposes of this definition, based on specific circumstances.

XXIX. "Bank", for the purposes of RSA 77-A:1, XXIV, means any entity that is a "bank," "national bank," or "bank holding company" as those terms are defined in RSA 384-B:1.

HISTORY: SOURCE. 1970, 5:1. 1971, 515:1, 2, 5. 1973, 544:11, VII; 579:2, 3. 1975, 503:2--4. 1977, 588:28. 1979,

446:1. 1981, 445:1--3. 1982, 42:91. 1983, 318:1, 2; 444:1. 1985, 414:6--9. 1986, 153:2, 3, 8. 1987, 407:1--4. 1988, 23:6. 1989, 50:15. 1991, 67:9--11; 354:6; 362:1. 1993, 313:9, 10; 350:5--7. 1994, 178:1; 326:4. 1995, 45:3, eff. July 2, 1995.

NOTES:

REFERENCES IN TEXT. Section 671 of the United States Internal Revenue Code, referred to in par. 1, is classified to 26 U.S.C. § 671.

The United States Internal Revenue Code of 1986, referred to in par. XX(h), is classified to 26 U.S.C. § 1 et seq.

Section 851 of the United States Internal Revenue Code, referred to in par. XXI, is classified to 26 U.S.C. § 851.

Section 3 of the Investment Company Act of 1940, referred to par. XXI, is classified to 15 U.S.C. § 80a-3.

Chapter 6 of the Internal Revenue Code, referred to in subpar. III(a), is classified to 26 U.S.C. §§ 1501-1505, 1551-1564.

Sections 1221, 170 and 3304 of the Internal Revenue Code, referred to in pars. IX and X, are classified, respectively, to 26 U.S.C. §§ 1221, 170 and 3304.

AMENDMENTS—1995. Paragraph XX(h): Added.

Appendix 3[*]

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TITLE V. TAXATION
CHAPTER 77-A. BUSINESS PROFITS TAX

RSA 77-A:3 (1995)

77-A:3. Apportionment

I. A business organization which derives gross business profits from business activity both within and without this state, and which is subject to a net income tax, a franchise tax measured by net income, or a capital stock tax in another state or is subject to the jurisdiction of another state or [sic] impose a net income tax or capital stock tax upon it, whether or not such tax is actually imposed, shall apportion its gross business profits so as

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[*Petitioners note that the statutes (N.H. Rev. Stat. Ann. §§ 77-A:1, 77-A:3) in effect for the years at issue (1987-1989), which were amended over the years in minor respects having no bearing upon the controversy before this Court, are substantially similar to the statutes attached as Appendices 2 and 3 by the Superior Court to its Interlocutory Transfer Without Ruling Statement and reproduced herein. It is noted that, in computing the apportionment fraction, the sales factor currently has a 1.5-weighting, was double-weighted for a period of time, and was single-weighted during the years at issue.]

to allocate to this state a fair and equitable proportion of such business profits. Except as provided in this section, such apportionment shall be made on the basis of the following 3 factors:

(a) The percentage of value of the total real and tangible personal property owned, rented and employed by the business organization everywhere as it owned, rented and employed by it in the operation of its business in this state. Property owned by the business organization shall be valued at its original cost. Property rented by the business organization shall be valued at 8 times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the business organization less any annual rental rate received by the business organization from subrentals.

(b) The percentage of total compensation paid by the business organization to employees everywhere as is paid by the business organization to employees for services rendered within this state. Such compensation is deemed to be disbursed for services in this state if the service is performed entirely within this state, or if the service is performed both within and without this state and the service performed without this state is incidental to the service within this state, or some of the service is performed in this state and (1) the base of operations or, if the [sic] is no base of operations, the place from which the service is directed or controlled is in this state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual performing such service resides within this state.

(c) The percentage of the total sales, including charges for services, made by the business organization everywhere as is made by it within this state. Sales of tangible personal property are made in this state if the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of f.o.b. point or other conditions of sale, or the property is shipped form [sic] an office, store, warehouse, factory or other place of storage in this state and (1) the purchaser is the United States government, or (2) the business organization is not taxable in the state of the purchaser. Sales other than sales of tangible personal property are in this state if the income-producing activity is performed in this state, or the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

NOTICE: FIRST OF TWO VERSIONS OF PARAGRAPH II Effective until July 1, 1999.

II. (a) A fraction, the numerator of which shall be the property factor in subparagraph I(a) plus the compensation factor in subparagraph I(b) plus 2.0 multiplied by the sales factor in subparagraph I(c) and the denominator of which is 4, shall be applied to the total gross business profits (less foreign dividends) of the business organization to ascertain its gross business profits in this state. If this method of apportionment does not fairly represent the business organization's business activity in this state, the business organization may petition for, or the commissioner may require, in respect to all or any part of the business organization's business activity, if reasonable:

(1) The exclusion of any one or more of the apportionment factors;

(2) The inclusion of one or more additional apportionment factors which will fairly represent the business organization's business activity in the state; or

(3) The employment of any other method to effect an equitable apportionment of the business organization's gross business profits.

(b) For foreign dividends from unitary sources, the following formula shall be used to modify factors relating to included dividends:

(1) Determine a percentage for each dividend payor consisting of dividends paid divided by taxable income which has been computed using United States standards.

(2) Apply this percentage to the dividend payor's foreign property, payroll, and sales.

(3) Sum the results in subparagraph (2) for all dividend payors.

(4) Add the result in subparagraph (3) to the denominators of the combined water's edge group. The numerator will remain the New Hampshire numerator.

(5) Apply the resulting percentage to the foreign dividends.

(6) Add this amount to the amount of New Hampshire taxable business profits computed pursuant to RSA 77-A:3, I and II(a).

NOTICE: SECOND OF TWO VERSIONS OF PARAGRAPH II
Effective July 1, 1999.

II. (a) A fraction, the numerator of which shall be the property factor in subparagraph I(a) plus the compensation factor in subparagraph I(b) plus 1.5 multiplied by the sales factor in subparagraph I(c) and the denominator of which is 3.5, shall be applied to the total gross business profits (less foreign dividends) of the business organization to ascertain its gross business profits in this state. If this method of apportionment does not fairly represent the business organization's business activity in this state, the business organization may petition for, or the commissioner may require, in respect to all or any part of the business organization's business activity, if reasonable:

(1) The exclusion of any one or more of the apportionment factors;

(2) The inclusion of one or more additional apportionment factors which will fairly represent the business organization's business activity in the state; or

(3) The employment of any other method to effect an equitable apportionment of the business organization's gross business profits.

(b) For foreign dividends from unitary sources, the following formula shall be used to modify factors relating to included dividends:

(1) Determine a percentage for each dividend payor consisting of dividends paid divided by taxable income which has been computed using United States standards.

(2) Apply this percentage to the dividend payor's foreign property, payroll, and sales.

(3) Sum the results in subparagraph (2) for all dividend payors.

(4) Add the result in subparagraph (3) to the denominators of the combined water's edge group. The numerator will remain the New Hampshire numerator.

(5) Apply the resulting percentage to the foreign dividends.

III. When 2 or more related business organizations are engaged in a unitary business, as defined in RSA 77-A:1, XIV, a part of which is conducted in this state by one or more members of the group, the income attributable to this state shall be determined by means of the combined apportionment factors of the unitary business group in accordance with paragraphs I and II.

IV. The business organization is entitled to a hearing by the commissioner on request in connection with any change in its apportionment procedure and has the right of appeal from the commissioner's determination as provided in RSA 21-J:28-b.

HISTORY: SOURCE. 1970, 5:1. 1971, 515:3. 1973, 544:9. 1979, 446:2, 3. 1981, 445:4. 1986, 153:5. 1991, 163:16; 354:7, 16. 1993, 350:11, eff. July 1, 1994, 350:12, eff. July 1, 1999.

NOTES:

AMENDMENTS—1993. Chapter 350:11 substituted "2.0" for "1.5" preceding "multiplied" and "4" for "3.5" preceding "shall be applied" in the first sentence.

Appendix 4

NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION CORPORATION BUSINESS PROFITS TAX RETURN

FORM
NH 1120 INST **1988**

GENERAL INSTRUCTIONS

WHO MUST FILE. A corporation including "S" corporations, domestic international sales corporations, foreign sales corporations, homeowners associations, or other form of organization required to file a federal corporate tax return must file provided they are carrying on business activity within New Hampshire and their gross business income is in excess of $12,000. Organizations that are exempt from income taxation under section 501 of the United States Internal Revenue Code (1986) in effect on 12/22/87 are also exempt from the business profits tax. Gross Business Income means the total sales, total rents received, and total other income items as included for federal income tax purposes, before deducting cost of sales, cost of operations or any other expenses.

WHEN TO FILE. If your federal income tax return is based on the calendar year your business profits tax return must be filed not later than March 15, 1989. If you file your federal income tax return on a fiscal year basis, you must file your annual Business Profits Tax Return on the same basis and not later than the 15th day of the third month following the close of your fiscal year (Example: F.Y.E. 6/30 due not later than 9/15).

WHERE TO FILE. Your return should be sent to the New Hampshire Department of Revenue Administration,

Returns Processing Division, 61 So. Spring St., P.O. Box 637, Concord, N.H. 03302-0637.

SIGNATURE. The return **must** be signed by an authorized officer of the corporation. If the return was prepared by someone other than an officer of the corporation, the preparer must also sign the return.

ATTACHMENT OF FEDERAL RETURNS. The New Hampshire Corporate Business Profits Tax Return, Form NH 1120, must be accompanied by a complete and legible copy of the corporation's federal return, Form 1120 (or 1120-S or other appropriate federal 1120 Form), pages 1, 2, 3, & 4 with supporting schedules. Your federal return is a required part of your New Hampshire Return and the failure to attach all schedules will subject the taxpayer to the failure to file penalty in accordance with the department's rule. (Rev. 307.13.)

HOW TO APPLY FOR EXTENSION OF TIME TO FILE. Form RP-104 should be used. The request for an extension must be made on or before the due date of filing the return. Internal Revenue Service extension approval, by itself, does not grant a Business Profits Tax Extension. A copy of the extension must be attached to your return at time of filing. Interest accrues at the annual rate of 15% on payments not made by the original due date of the return. Refer to the reverse side of Form RP-104 for specific instructions. There is no extension of time for the payment of tax.

INTEREST. Any business organization which fails to make payment when due shall pay interest computed at the annual rate of 15% from date due to date paid.

PENALTIES:

Failure to Pay. A penalty equal to 10% of any nonpayment or underpayment of taxes shall be imposed if the taxpayer fails to pay when due and the failure to pay is due to willful neglect or intentional disregard of law but without intent to defraud. If the failure to pay is due to fraud, the penalty shall be 50% of the amount of the nonpayment or underpayment.

Failure to File. A taxpayer failing to timely file a complete return will be subject to a penalty equal to 5% of the tax due or $10, which ever is greater, for each month or part thereof. The total amount of this penalty shall not exceed 25% of the total tax due or fifty dollars, which ever is greater. The penalty is imposed on the net amount of any tax due after crediting any payment made through estimating or other means. This penalty will be imposed starting with the due date of the return.

Underpayment of Estimated Tax. If there was an underpayment or late payment of your 1988 estimated tax requirement, form RP-2210/2220 must be completed to compute the penalty or determine if any of the exceptions apply.

CONSOLIDATED RETURNS. Corporations which are included in a federal consolidated return are not permitted to file a consolidated tax return for New Hampshire Business Profits Tax purposes. Such corporations must report, as their gross business profits, the amount which would have been shown as their taxable income before the net operating loss deduction and special deductions if they were not part of the federal consolidated group and a separate tax return had been required. Taxpayers must

submit a pro-forma federal return showing the corporation's separately computed taxable income before net operating loss deduction and special deductions and attach the federal consolidating schedules filed with the Internal Revenue Service.

COMBINED RETURNS FROM A "WATER'S EDGE" COMBINED GROUP: Corporations that are conducting a unitary business within and outside of New Hampshire must file a combined business profits tax return on a "water's edge" basis. Combined reporting does not apply unless a portion of the business activity is conducted outside of New Hampshire and a member of the unitary group is subject to the taxing jurisdiction of another state. See the specific instruction on filing a combined return and the department's rules (Rev 300) for additional information.

"S" CORPORATION. The federal tax distinction between an "S" and a regular corporation is not recognized by the Business Profits Tax Law. Therefore, corporations which file a federal form 1120-S are required to adjust the profit (or loss) line of the federal form. Complete Form RP 120 Computation of "S" Corporation Gross Business Profits. New Hampshire does not permit the flow through of income and expense items to the "S" shareholders.

DECLARATION OF ESTIMATED TAX. Every business organization shall file a declaration of its estimated business profits tax for its subsequent taxable period. See the instruction with the Estimated Tax Declaration Form for the 90% provision, and for penalties regarding the underpayment of estimated taxes. In the case of a combined group of unitary businesses, the declaration must be filed

by the principal New Hampshire business organization on behalf of the "water's edge" combined group.

AMENDED RETURNS. Form NH 1120 should also be used when filing an amended corporation business profits tax return. Write in the words "AMENDED RETURN" at the top of the form. Amended returns are subject to the statute of limitations as provided in RSA 77-A:13 and 21-J:29.

CHANGES IN YOUR FEDERAL INCOME TAX RETURN. You must report any change or correction of your Federal tax return whether initiated by you or by the Internal Revenue Service. (RSA 77-A:10). Any changes should be reported using form RP-87 in separate correspondence to Returns Processing Division, 61 So. Spring St., P.O. Box 637, Concord, N.H. 03302-0637.

REFERENCES TO FEDERAL FORMS. All references to federal tax forms and form lines are based upon draft forms available at the time the State forms were drafted. In all instances, both Federal line number and description have been included, if these do not match, follow the line description or contact the Department of Revenue Administration.

FEDERAL PASSIVE LOSS RULES. The Federal passive loss limitation rules are not used in determining your taxable business profits. Every effort has been made in the design of this form to prevent this federal provision from affecting your New Hampshire taxable income. Federal passive loss limitations should not limit the amount of State loss nor should accumulated Federal passive losses from previous taxable periods be used to adjust the gain or loss or any business asset sold.

ANY QUESTIONS concerning this return should be referred to the Taxpayers Assistance Office, 61 South Spring St., P.O. Box 457, Concord, NH 03302-0457. Tel. (603) 271-2191 or, if calling within New Hampshire, 1-800-525-8297.

COMPLETE YOUR FEDERAL RETURN FIRST AS IT IS THE BASIS FOR COMPLETING YOUR NEW HAMPSHIRE BUSINESS PROFITS TAX RETURN.

FORM
NH 1120 INST **1998**

CORPORATION BUSINESS PROFITS TAX RETURN
LINE BY LINE INSTRUCTIONS

In completing this return start with Page 2 of Return

LINE 1 GROSS BUSINESS PROFITS:

(a) Enter the amount of taxable income before application of the net operating loss deduction or other special deductions from the federal corporate tax return. "S" corporations must complete N.H. Form RP-120 Computation of "S" Corporation Gross Business Profits to arrive at the amount to be included on this line. Other corporations filing special federal corporate tax returns must include the taxable income that is comparable to a regular corporation's "taxable income before net operating loss deduction and special deductions". Corporations filing a federal consolidated return must include the amount which would have been shown as their taxable income before net operating loss deduction and special deduction if

they were not part of the federal consolidated group and a separate return had been required.

Corporations filing a combined return must enter the combined taxable income before net operating loss and special deductions from the required combining schedule. See the specific instructions for filing combined returns.

(b) Separate entity adjustment. Enter the amounts (accompanied by supporting schedules where necessary) which arise from the necessity of adjusting gross business profits to accommodate the New Hampshire requirement of separate entity treatment for business organizations. Examples are the adjustments required under IRC § 857(b)(2) for real estate investment trusts and IRC § 852(b)(2) for regulated investment companies, or partners share of the partnership activities reported on the corporate return. (Rev 302.02).

(c) Combine lines 1(a) and (b).

LINE 2 ADJUSTMENTS TO GROSS BUSINESS PROFITS:

(a) Safe Harbor Leases:

Seller/Lessee: Add – Acquisition price of benefits
Deduct – Professional cost incurred, rental expense, interest expense, depreciation or ACR deduction taken on federal return.

Buyer/Lessor: Deduct – Acquisition price of benefits, professional cost incurred, rental income.
Add – interest expense, depreciation or ACR deduction taken on federal return.

Refer to RSA 77-A:4-a and rule Rev 303.02 for further information.

(b) Income Tax Add-Back. Enter the total Business Profits Tax, income tax, franchise tax measured by net income, or capital stock tax, assessed by any state or political subdivision that was deducted on this year's federal return.

(c) Internal Revenue Code (1954 as amended) Section 337. Gain from sale of assets pursuant to a plan of liquidation must be included in New Hampshire taxable income of the corporation. (RSA 77-A:4, VIII). This requirement continues for any corporation that meets the exception requirements allowing the federal nonrecognition provision of section 337 to apply as provided in the Tax Reform Act of 1986.

(d) A deduction of such amount of gross business profits as is attributable to income derived from interest on notes, bonds or other securities of the United States.

(e) A deduction for the adjustment required by Internal Revenue Code Section 280C and entered on Line 13(b), Page 1 Federal

Form 1120 or the comparable line from 1120S or other 1120 forms.

(f) In the case of a corporation which is the parent of an affiliated group pursuant to the provisions of Chapter 6 of the United States Internal Revenue Code (1986) in effect on 12/22/87, a deduction of such amounts of gross business profits as are derived from dividends paid to the parent by a subsidiary or subsidiaries whose gross business profits have been subject to taxation under the Business Profits Tax Law during the same taxable period (attach a supporting schedule giving amount, name and F.E.I. No. of payer.) Additionally, in the case of a corporation which received certain intangible income from non-unitary sources, a deduction from gross business profits for the amount of such income (*net of related expenses*), (attach a supporting schedule giving amount, name and F.E.I. No. of payer).

(g) In the case of a corporation which is a participant in a joint venture which itself is taxable under the Business Profits Tax Law, a deduction of such amounts of gross business profits as are derived from distributions from the joint venture to the corporation and which have already been subject to taxation under this chapter during the same or an overlapping fiscal period (attach a supporting schedule giving amount, name and F.E.I. No. of payer).

(h) A deduction of such amount of gross business profits as is attributable to foreign

dividend gross-up as determined in accordance with Section 78, United States Internal Revenue Code (1986) in effect on 12/22/87.

(i) In the case of a business organization which makes qualified research contributions as defined in RSA 77-A:1, X, the gross business profits shall be adjusted by: (a) adding to gross business profits the amount deducted under section 170 of the United States Internal Revenue Code (1986) in effect on 12/22/87 in arriving at federal taxable income; and (b) deducting from gross business profits an amount equal to the sum of the taxpayer's basis in the contributed property plus 50 percent of the unrealized appreciation, or twice the basis of the property, whichever is less.

(j) Combine lines 2(a) through 2(l).

LINE 4 APPORTIONMENT. A corporation, which derives gross business profits from business activity both within and without this state and which is subject to a net income tax, a franchise tax measured by net income, or a capital stock tax in another state or is subject to the jurisdiction of another state to impose a net income tax or capital stock tax upon it, shall apportion its gross business profits so as to allocate to this state a fair and equitable proportion of such business profits. Those corporations which apportion business profits shall use New Hampshire form RP 80, Apportionment of Income. Refer to the reverse side of RP 80 for specific instructions concerning the three factors (Sales, Payroll, and Property) of

apportionment. Corporations not apportioning must use a factor of 1.

LINE 5 TAXABLE BUSINESS PROFITS: Multiply line 3 by line 4. Enter result and proceed to page 1, line 6.

LINE 8 CREDITS:

(a) Enter amounts paid with Application for Extension. (Attach a copy of extension to return).

(b) Enter estimated payments to be applied.

(c) Enter the prior year overpayment carried over.

(d) Other credits allowed are: (1) taxes paid pursuant to RSA 83-C, Franchise tax paid by public utilities, (2) taxes paid pursuant to RSA 84, taxation of banks-tax imposed on value of capital stock of national banks and franchise tax on bank interest, dividends and divided profits, (3) taxes paid pursuant to sections of RSA 400-A, relating to taxation of insurance companies. The total amount of any such credit allowed shall not exceed the tax due under this chapter.

(e) When filing an amended return enter the amount of payment remitted with original return.

(f) RSA 162-L:10 Provides for a business profits tax credit to a business organization which makes a contribution to a community development finance authority and in the same year purchases common stock of the authority. The credit which may be carried forward is equal to 75% of

the stock's purchase price but may not exceed 75% of the contribution made.

LINE 9 BALANCE OF TAX DUE. Subtract line 8(g) from line 7.

LINE 10 INTEREST & PENALTIES:

(a) **Interest.** The annual rate of interest for all taxes due is 15% calculated from the due date to the date paid on the balance of tax due on line 9.

(b) **Failure to Pay Penalty**. Multiply nonpayment or underpayment amount on line 9 by 10% (see General Instructions for applicability).

(c) **Failure to File Penalty.** If the return is late, multiply the balance of tax due on line 9 by 5% for each month or part thereof, for which the return is filed beyond the due date. The total shall not exceed 25% of the balance of tax due or $10 for each month up to $50 whichever is greater.

(d) **Underpayment of Estimated Tax.** Calculate the penalty for late payment or nonpayment of estimated tax on form RP2210/2220 and attach the form to this return. You must also attach a copy if you qualify for one of the exceptions provided for in RSA 21-J:32.

LINE 11 BALANCE DUE. If the Balance of Tax Due (line 9) is being paid after the due date of the return, interest must be added (line 10(a)). If the amount due is after the due date and an extension of time to file has not been granted, then failure to pay or failure to file penalties may apply. See the general instructions and the

instructions for line 10(b) and (c) above. Payment must accompany the return. Make the check payable to the State of New Hampshire and include the corporation's federal identification number on the front of the check.

LINE 12 OVERPAYMENT. If line 8(g) is greater than line 7, subtract line 7 from line 8(g) and enter on line 12. If the payment of tax was not timely made or the estimated tax provisions were not met, the overpayment must be reduced by interest and penalty for not properly making estimated tax payments.

LINE 13 APPLY OVERPAYMENT. The taxpayer has an option of leaving any part or total of any overpayment as a credit on its next year return. Enter the desired credit on line 13(a). The remainder desired as a refund should be entered on line 13(b). If line 13 is not completed, the entire overpayment will be refunded.

NOTE: A corporate officer must sign the return and attach all required schedules for the return to be considered a properly filed return.

Specific Instructions For Filing Combined Returns

NH 1120 Inst

(See the general instruction for applicability)

1. The return, extension and declaration of estimated tax must be filed by the entity having the greatest New Hampshire activities in the *first year* a combined return is filed and changed *only when* the entity is no longer subject to New Hampshire's jurisdiction, at which time the combined group will designate a new entity. The Department of Revenue Administration

must be notified of such a change by attaching a statement to the front page of the New Hampshire return.

2. Informational business profits tax forms shall be prepared by all members, other than the principal New Hampshire business organization of the combined group, having nexus with the State. Such informational returns shall be filed using the appropriate business profits tax return (NH-1120, NH-1065, NH-1040, NH-1041) and include the name, address, federal identification number, or social security number of the business organization and attach a statement indicating that it is a member of a combined return listing the name and federal identifying number of the principal New Hampshire business organization.

3. A combined business profits tax return shall contain the following forms and/or schedules:

   a. a combining profit and loss statement in columnar form disclosing each organization's profit or loss and intercompany eliminations.

   b. A schedule in columnar form disclosing the various adjustments for each organization necessary to convert the combined profit and loss statement to the combined income subject to apportionment.

   c. A schedule of apportionment formula in columnar form disclosing for each organization the total amount of sales, payroll and property and the amount of New Hampshire sales, payroll and property. This schedule shall be prepared after all intercompany activity has been eliminated.

   d. An affiliations schedule (NH 851)

4. All transactions between companies included in the combined return shall be eliminated.

5. A statement signed by the authorized agent of all business organizations notifying the commissioner of any change in the status or composition of the unitary business.

6. A combined report shall be filed using the taxable period of the principal New Hampshire business organization. Any member of the group not having the same taxable period must convert its income and expenses to the taxable period of the principal New Hampshire business organization for use in both the tax base and apportionment factors.

7. All business organizations conducting a unitary business shall be included in a combined report unless a certification agreement, form AU-20, as provided in paragraph (10) has been prepared and filed with the Department's Audit Division prior to the extended due date of the combined return.

8. A combined business profits tax return shall be filed on or before the 15th day of the third month following the close of the principal New Hampshire business organization's taxable period. Extensions of time for filing combined returns may be granted provided the request is made by the principal New Hampshire business organization before the original due date for filing a combined return. Request should be made using form RP 104.

9. The principal New Hampshire business organization required to pay estimated taxes on the combined net income of the combined group, as provided in RSA 77-A:6, II, shall use a NH-1120-ES form and file such form with payment on or before the 15th day of the fourth, sixth, ninth, and twelfth month of the taxable period to which they relate.

10. For purposes of the exception provisions for overseas business organizations in Section XV of RSA 77-A:1,

the taxpayer shall be required to certify that transactions between members of the combined group and qualified overseas business organizations are made at an arms length price. "Certification," for purposes of RSA 77-A:1, XV, shall be effectuated only through the certification Form AU-20.

APPENDIX E

Before the
DEPARTMENT OF REVENUE ADMINISTRATION
ADJUDICATIVE PROCEEDING
FINAL ORDER

Re: Caterpillar, Inc.
Docket Number 91-85D
Business Profits Tax: tax years ending 1987, 1988 and 1989

JURISDICTION AND SUMMARY OF THE CASE

An adjudicative proceeding in the above-captioned matter was held February 19, 1993, in the offices of the Department of Revenue Administration, 61 South Spring Street, Concord, New Hampshire, pursuant to RSA 21-J:28-b and Chapter 200 of the Administrative Rules of the Department of Revenue Administration. The purpose of this proceeding was to permit Caterpillar, Inc. (hereinafter "taxpayer") the opportunity to present evidence and argument concerning assessment of additional business profits tax.

Taxpayer filed a proper petition for hearing on September 27, 1991. Such petition disputed division treatment of foreign subsidiary dividend income and requested consideration for an alternate apportionment procedure pursuant to RSA 77-A:3, II.

Taxpayer's petition was forwarded to the Audit Division of the Department of Revenue Administration (hereinafter "division") for review and response. Division response was received and forwarded to taxpayer on December 9, 1991.

Notice of hearing was issued October 2, 1992, setting a date for hearing on February 19, 1993.

Taxpayer subsequently submitted a supplemental memorandum of law which was received by this office and forwarded to division on February 8, 1993.

Division was represented at the adjudicative proceeding by John Mintken, Chief, Multistate Audit and Peter Garre, Tax Auditor, Multistate Audit. Taxpayer was represented at the proceeding by Daniel J. Schlicksup, Esquire and Robert L. Goben, Tax Accountant.

RECORD OF THE CASE

The findings of fact and conclusion of law in this case are based on the following:

A. Taxpayer petition dated September 20, 1991.

B. Division case report dated December 5, 1991.

C. Taxpayer supplemental memorandum of law dated February 3, 1993.

D. Electronic recording of the proceeding held on February 19, 1993.

E. Taxpayer exhibits submitted at the proceeding held on February 19, 1993.

F. Taxpayer post-petition documents submitted March 17, 1993.

STATUTES AND REGULATIONS AT ISSUE

1. RSA 77-A:3, II. (1991).
2. RSA 77-A:3, IV. (1991).
3. Rev. 304.05

TAXPAYER CONTENTION

In memoranda and oral argument, taxpayer asserts that the inclusion of foreign interest, royalty, dividend and sub-part F income in apportionable income and the use of the bifurcated apportionment formula under RSA 77-A:3, II., violates the U.S. Constitution. Additionally, taxpayer argues that the New Hampshire statutory apportionment formula does not fairly represent their business activity in the state. Accordingly, taxpayer requests modification of the apportionment method.

Summary and Finding of Fact

1. Taxpayer is incorporated in Delaware and has its principal place of business in Illinois. Caterpillar is engaged in the business of manufacturing and selling construction equipment and engines throughout the world. Caterpillar has domestic and foreign subsidiaries. Caterpillar and its subsidiaries do not maintain a place of business in New Hampshire. The activities of Caterpillar and its domestic subsidiaries within the state of New Hampshire are limited to the ownership of property located within the state and the sale of product to independent dealers located within the state. The foreign subsidiaries have no activities within the state of New Hampshire. Caterpillar is subject to the New Hampshire Business Profits Tax.

2. Division conducted an audit of taxpayer's books and records during January 1991. On March 28, 1991, a proposed assessment was sent to taxpayer. On June 7, 1991, taxpayer proposed modification of the New Hampshire apportionment formula.

3. Taxpayer's proposal to modify was denied and a tax notice was issued on August 7, 1991.

4. On September 27, 1991, taxpayer filed a proper petition for hearing. In such petition, taxpayer repeated their request for modification of the bifurcated formula pursuant to RSA 77-A:3, II. (a).

5. A notice of hearing was sent to taxpayer pursuant to RSA 541-A which expressly identified the issue to be addressed at taxpayer's adjudicative proceeding to include whether, "Division improperly denied taxpayer alternate method of apportionment pursuant to RSA 77-A:3, II. (a), regarding federal subpart F income."

MEMORANDUM

As stated above, taxpayer challenges New Hampshire statute by questioning the constitutiality [sic] of inclusion of foreign interest, royalty, dividend and subpart F income in apportionable income; of the use of the bifurcated apportionment formula; and of exclusion of the property, payroll and sales factors which generate foreign interest and royalty income in apportionable income. Taxpayer realizes, however, that the hearing officer in this adjudicative proceeding lacks jurisdiction to render a decision on constitutional challenges and declines to rule on these issues.

Alternatively, taxpayer requests an alternate method of apportionment to calculate their business profits tax which would fairly represent their business organizations business activity in this state.

RSA 77-A:3, II. (a), provides that for those taxpayer's where the statutory method of apportionment does not fairly represent the business organization's business activity in this state, the business organization may petition for employment of "any other method to effect an equitable apportionment of the business organization's gross business profits." Such requests must be forwarded to the Department of Revenue Administration pursuant to RSA 77-A:3, II. (a). A formal procedure for requesting modification of the apportionment provisions is set out in administrative rule Rev. 304.05, "Business Organizations Seeking a Modification of Apportionment Provisions." Attachment A. Pursuant to this rule, a petition for apportionment modification must initially be submitted to the director of audit for consideration. Rev. 304.05(d). In the event a request for modification is denied, taxpayer's may appeal such denial through the adjudicative procedure.

Taxpayer's petition in this case, dated September 20, 1991, requested modification of the apportionment formula. The division response to such petition, dated December 5, 1991, states that the taxpayer's proposal to modification was denied.

In the course of the adjudicative proceeding held on February 19, 1993, for this case, it came to light that taxpayer's request for modification was not properly submitted per the requirements of Rev. 304.05, and accordingly, was not properly denied prior to this appeal.

It would be improper to consider taxpayer's request via adjudicative proceeding prior to appropriate petition, review and denial.

CONCLUSION OF LAW

Taxpayer request for modification of apportionment provisions must be considered pursuant to the procedure set out at Rev. 304.05 prior to review and consideration via adjudicative proceeding.

ORDER

Upon the basis of the foregoing findings of fact and conclusions of law, taxpayer's request for modification is denied.

/s/ Dianna L. Lowry
Dianna L. Lowry
Hearing Officer

September 29, 1993
DATE

APPROVED

/s/ Stanley R. Arnold
Stanley R. Arnold
Commissioner

September 30, 1993
DATE

Rev 304.05 Business Organizations Seeking a Modification of Apportionment Provisions.

(a) Any business organization which desires to modify the statutory apportionment formulas provided in RSA 77-A:3 shall petition the commissioner for approval prior to using the modified formula. A copy of the commissioner's approval letter shall be attached to all subsequent returns filed.

(b) The petition for modification of the apportionment formula shall be submitted separately and not attached to a tax return being filed. The petition shall be mailed to the following address:

Commissioner of Revenue Administration
61 South Spring Street
P.O. Box 457
Concord, NH 03302-0457

(c) The petition for apportionment modification shall set forth a complete statement of the facts relating to the request and shall include the following:

(1) Full names and addresses, and if applicable, federal identifying numbers, social security numbers or department license numbers of all interested parties.

(2) A full and precise statement of the necessity for the modification.

(3) A carefully detailed description of the business activity which necessitates the modification.

(4) Evidence supporting the business organization's petition including any court decisions on the matter, true copies of all contracts, deeds, agreements, instruments or other documents which evidence the necessity of the modification.

(5) Reference to the RSA sections relating to the subject of the petition.

(6) A description of the modified formula proposed by the business organization.

(7) A statement whether, to the best of the petitioner's knowledge, the modification is the

subject of prior petition requests of a similar or identical factual nature.

(d) Any petition for apportionment modification received by the commissioner shall be submitted to the director of audit for advice and recommendation. The director of audit shall forward the recommendations to both the petitioner and the commissioner. If the petitioner is aggrieved by the recommendation of the director of audit, the petitioner may appeal the recommendation and request a hearing on the petition in the same manner as an adjudicative proceeding involving the administration, assessment, or refund of taxes governed by Chapter 200 of the department's administrative rules. Such appeal shall be filed within 60 days of the issuance of the recommendation of the director of audit.

(e) The use of a separate accounting result which differs from the standard apportionment result shall not prove the need for or the acceptability of a modified apportionment formula.

(f) The use of a modified apportionment formula by a business organization without the prior written approval or order of the commissioner shall constitute a willful violation of the statutory requirements of RSA 77-A:3. No return which includes such a willful violation of RSA 77-A:3 shall be considered timely filed for purposes of RSA 77-A:6, RSA 77-A:1,VII; and PART Rev 307 until such approval has been obtained from or ordered by the commissioner. In instances of such a late request, a return shall be considered filed upon the date of the commissioner's approval or order. If the commissioner disapproves a later requested filing, no return shall be considered filed by the business organization until a proper apportionment schedule is submitted to the department.

APPENDIX F

IN THE CIRCUIT COURT OF THE
SECOND JUDICIAL CIRCUIT,
IN AND FOR LEON COUNTY,
FLORIDA

Case No. 95-1290

CATERPILLAR INC.,
CATERPILLAR AMERICAS CO.,
CATERPILLAR FINANCIAL
SERVICES CORP. and
SOLAR TURBINES INC.,

Plaintiffs,

v.

STATE OF FLORIDA,
DEPARTMENT OF REVENUE,
and LARRY H. FUCHS, in his
official capacity as
Executive Director,

Defendants.
_____/

ORDER DEFERRING RULING ON MOTION FOR SUMMARY JUDGMENT AND ALLOWING PARTIES TO SUPPLEMENT AFFIDAVITS

This matter is before the court on the petitioner's motion for summary judgment. The court has reviewed the motion and memoranda submitted by the respective parties in light of the affidavits and other records in the file. For the reasons that follow, the court has determined that a decision should be deferred until the parties have had an opportunity to determine whether the issue in controversy can be resolved by the use of the relief provisions of Florida Statutes, Sections 220.44 and 214.73

(1987). Therefore, the court will defer ruling for a period of 60 days until such time as the parties are able to address this issue. The parties may submit supplemental affidavits and the court will consider the motion for summary judgment once again if the case is not settled.

The plaintiffs have advanced a persuasive argument that the Florida consolidated reporting method discriminates against foreign commerce by making an arbitrary distinction between domestic and foreign income. In support of this argument they rely on *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 112 S.Ct. 2365 (1992), a case that is difficult to distinguish. In this case as in *Kraft*, the system of apportionment appears to overstate foreign income in relation to the total taxable income attributable to the activities of the taxpayer in the State of Florida. The Department counters this point by arguing that interest and royalties are treated the same under Section 220.11 regardless of the source, and that dividends are subtracted from taxable income under Section 220.13(1)(b)(2)(a), regardless of the source. However, these statutes are apparently not applicable to subsidiary corporations within a unitary group. If that were the case, the plaintiffs' foreign source income would have been excluded and they would have had no reason to assert a claim in this case.

Nevertheless, the court is persuaded that the relief provisions of Section 214.73 (1987) and Section 220.44 (1987) may cure a potential constitutional defect in the consolidated tax system. Therefore, the court has concluded that the plaintiffs should be given an opportunity to pursue these statutory relief provisions to determine

whether the controversy can be resolved short of a declaration the statute is invalid. This course of action is consistent with the court's duty to uphold the validity of a state law when possible. For these reasons, the court has concluded the petitioner should be given an opportunity to pursue the relief provisions of Section 214.73 (1987) and Section 220.44 (1987). The court will defer ruling on the motion for summary judgment for a period of 60 days. If the issue is not settled, either party may submit further affidavits relating to their ability or inability to use the relief provisions.

The plaintiffs correctly pointed out that the Department is not required to grant relief from a previous tax determination. Likewise, it is clear that the court has no power to force the plaintiffs to proceed with a request for relief as a condition of its argument that the statute is unconstitutional. However, the positions the parties take on this issue is likely to affect the court's ruling on the pending motion for summary judgment. If the tax assessment discriminates against foreign commerce and if the Department makes no effort to provide relief, then the court may have a basis to conclude that the statute is unconstitutional, at least as it was applied to the plaintiffs. On the other hand if the plaintiffs elect to proceed without attempting to obtain relief from the tax they complain of in this case, the court is likely to view the uncertainty regarding the effect of the relief provisions as a basis to deny the motion for summary judgment. In that event, the issues could be considered in a plenary hearing on the merits and the court would still have the ability to rule on the plaintiffs' claim the statute is facially unconstitutional.

DONE AND ORDERED in Chambers, Tallahassee, Leon County, Florida on May 2, 1996.

/s/ Philip J. Padovano
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Circuit Judge

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(2)

No. 99-1214

IN THE

Supreme Court of the United States

CATERPILLAR INC., CATERPILLAR FINANCIAL SERVICES CORPORATION, AND SOLAR TURBINES INCORPORATED,

Petitioners,

v.

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION AND STANLEY R. ARNOLD, JR., THE N.H. COMMISSIONER OF REVENUE,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION AND STANLEY R. ARNOLD, COMMISSIONER

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February 22, 2000

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RESTATED QUESTION PRESENTED

1. Does the New Hampshire Business Profits Tax discriminate against foreign commerce because of the requirement of "water's edge" combination, which includes (a) the net income and (b) the factors only of the water's edge (i.e., domestic) members of a unitary group of businesses in calculating the group's tax base and the percentage of the group's income that will be taxed by New Hampshire, respectively, which does not include the net income and factors of any other entity regardless of location, including the foreign members of the larger unitary group, in determining the group's tax base and apportionment percentage?

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THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION AND STANLEY R. ARNOLD, JR., THE NEW HAMPSHIRE COMMISSIONER OF REVENUE,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION

Respondents respectfully request that this Court deny the Petition for Writ of *Certiorari* (the "Petition") seeking review of the decision of the New Hampshire Supreme Court in this case. While there is not yet an official reported version of the decision below, it is reported as *Caterpillar Inc., Caterpillar Financial Services Corporation, and Solar Turbines Incorporated v. New Hampshire Department of Revenue Administration and Stanley R. Arnold, Jr., New Hampshire Commissioner of Revenue,* at 741 A.2d 56 (1999) and at 1999 N.H. Lexis 106.[1] (*"Caterpillar (N.H.)"*).

STATEMENT OF THE CASE

Respondents (the "State") submit the following additional information to supplement and correct Petitioners' statements of fact, descriptions of New Hampshire's business tax system, and the proceedings below.

[1] Petitioners have included a copy of the New Hampshire Supreme Court's decision in their Appendix beginning at 1a. In this Brief, Respondents will cite to items included in Petitioners' Appendix by referring to "Petitioners' App." and then the page number.

A. Supplemental Facts.

As Petitioners stated, the facts of this case, which were stipulated to, are not in dispute. Even though Petitioners have generally summarized accurately the pertinent facts regarding the organization and operation of their business, certain additional stipulated facts are necessary for the proper analysis of the issues in this case. Also, although the State generally agrees with Petitioners' background description of the State's application of the unitary tax system, there are some important errors and omissions that should be noted.[2]

The State does not agree with the tax example outlined in the Petitioners' Statement of the case as it does not reflect a realistic situation and does not accurately explain the workings of the water's edge combination under the New Hampshire Business Profits Tax (the "Business Profits Tax"). For example, the hypothetical $300 million dollar payments by Subsidiary Y would be reflected in Company A's apportionment formula in the denominator of the sales factor. As a result, only a fraction of the payment would be apportioned to New Hampshire. Thus, without knowing all of A's income and factors, it is impossible to determine the overall effect of Y's payment on A's tax obligation to New Hampshire and whether the obligation would be greater or less than if Y were a domestic subsidiary.

Also, Footnote 1 included in the Petition is an inaccurate reflection of how the Business Profits Tax works. Under the Business Profits Tax, payment to a parent by a domestic unitary subsidiary is included as income in the combined amount, however, it is offset by the expense recognized by the subsidiary. As explained further below, the concepts of

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[2] Of course, the State does not subscribe to the conclusory comments regarding the alleged overstatement of income and the discriminatory treatment of the State's water's edge system included in the Petitioners' Statement of the case.

"shifting back" or "elimination" are relevant to the calculation of a taxpayer group's apportionment percentage, not to the calculation of the group's tax base. The result is that the transaction is essentially invisible for purposes of calculating the tax base.

B. Determining The Tax Base Under The Business Profits Tax.

The apportionable tax base for a unitary group of business organizations in New Hampshire is determined by the "water's edge method" of combined reporting. This method requires the combining of the net incomes (or losses), based on federal taxable income, of the members of the unitary group, except "overseas business corporations" (hereinafter "foreign corporations" or "foreign subsidiaries").

Because the apportionable tax base is the income of the combined group as a whole, transactions between members of the combined group do not affect the group's combined income. When a subsidiary pays royalties and interest to its parent, the income recognized by the parent is offset by the expense recognized by the subsidiary, thus making the transaction invisible for purposes of calculating the tax base. The apportionable tax base of the combined group includes any income received from a party outside the combined group and any expense paid to a party outside the combined group – income is added; expenses are subtracted. Because foreign corporations (whether unitary or not) are not part of the combined group, royalties and interest received by the group from foreign corporations, as well as expenses paid to foreign corporations, are added and subtracted, as appropriate, in computing the tax base of the group, as are transactions with unrelated third parties.

The apportionable tax base is allocated to the State using an apportionment percentage computed under a three-fac-

tor apportionment formula. The "water's edge group's" New Hampshire property, payroll, and sales are divided respectively by the total property, payroll and sales of all business organizations included in the combined group, *i.e.*, all unitary domestic corporations. The average of these fractions is the apportionment percentage.

The income taxed by the State is determined by multiplying the apportionment percentage by the combined net income of the water's edge group. Because the net income recorded by a foreign corporation is not included in the water's edge group's tax base, none of the foreign corporation's income is, or can be, apportioned to the State through the apportionment formula. Similarly, because the net income of the foreign corporation is not included in the combined group's tax base, the property, payroll, and sales factors of the foreign corporation are not used to apportion the income of the combined group among the states in which the members do business.

C. Calculating The Apportionment Percentage.

The next step in the process is calculating the percentage of the tax base apportioned to New Hampshire. Intercompany payments such as royalties and interest are not separately identified or treated in determining the aggregate tax base in a combined return. Since the aggregation (or "combination") of the base occurs at the level of net income, these payments are invisible: A receipt to one entity in the group is another's deduction. Therefore, no actual "elimination" of the payment takes place.

In calculating the combined apportionment percentage, however, such payments of royalties and interest must be eliminated from the combined sales factor by a tax accounting entry in order to avoid double counting. The combined sales factor is derived from aggregating *gross* receipts with-

out taking into account any deductions. This is because the factor is intended to be part of a calculation to approximate business activity in the state, not profit. Because there is no corresponding deduction on the part of the payor entity, absent such elimination, the sales factor would not accurately reflect the activity within or without the state. *See* Example 3, at App. 12a-13a (illustration of the calculation of the tax base and apportionment factors of a unitary business group with intercompany payments).[3]

D. Royalty And Interest Payments Received By Combined Members Of A Unitary Group From Uncombined Unitary Foreign Subsidiaries.

The focus of the Foreign Commerce Clause dispute in this case is the treatment accorded royalty and interest payments received by some of the combined members of Petitioners' water's edge group from uncombined unitary foreign subsidiaries. The royalty payments were in exchange for licenses to use trademarks and technology owned and developed by Caterpillar Inc. ("Caterpillar") or other combined members of the unitary group. Stipulation of Facts ¶ 10, at App. 2a ("Stip. ¶ ___"). The interest payments were in return for loans made to the uncombined foreign subsidiaries by the members of the combined group. Stip. ¶ 10. Caterpillar and certain combined group members also received intercompany royalties and interest payments from some of the other domestic members of the group. Caterpillar may also have received royalties from unrelated foreign and domestic third parties to whom it licensed trademarks and technology. *See Caterpillar Fin. Servs. Corp. v. Whitley*, 288 Ill. App. 3d 389, 680 N.E.2d 1082, 1083 (App. Ct. 3d Dist.), *appeal denied*, 174 Ill. 2d 556, 686 N.E.2d 1158 (1997).

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[3] A short explanation of the workings of the New Hampshire Business Profits Tax is included in the Appendix to this Brief which shows, among other things, how to calculate a tax base and an apportionment percentage.

The uncombined foreign subsidiaries deducted the royalty and interest paid to Caterpillar on their respective foreign income tax returns.[4] Stip. ¶ 15, at App. 3a-4a. Caterpillar and any combined members of its group receiving such payments would include them as gross receipts on their federal income tax return. Stip. ¶ 15.

There are some serious flaws in Petitioners' description of the New Hampshire system of taxing unitary businesses with foreign subsidiaries. The Business Profits Tax is a net income tax. That is, the base upon which the tax is imposed is the current earnings remaining after adding all receipts from whatever source and deducting all expenses and losses. These current earnings are called "gross business profits," the basic element of which is federal taxable income. *See* N.H. Rev. Stat. Ann. § 77-A:1, III(a), at Petitioners' App. 37a. Royalty and interest receipts are not separately identified in the tax base, but only become a part thereof to the extent that income exceeds deductions in determining net income.

In order to comply with United States Constitutional constraints on the taxation of extraterritorial income, the Business Profits Tax statute "apportions" total net income based on a three-factor formula consisting of sales, payroll and property. *See Opinion of the Justices*, 128 N.H. 1 (1986). In the case of several legally discrete businesses operating as an functionally integrated unit – that is, business organizations satisfying the definition of a "unitary business" in N.H. Rev. Stat. Ann. § 77-A:1, XIV – the statute requires that the group file a combined return aggregating each members net income and apportionment factors. *See* N.H. Rev. Stat. Ann. § 77-A:6, IV, at App. 6a.

A system of taxation that aggregates the net incomes and factors of every member of the unitary business group wher-

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[4] Just as any of the other domestic or unrelated third party payors would have done.

ever located is called "worldwide combination." Until 1986, this was New Hampshire's taxing system. In that year, the New Hampshire Legislature adopted the current modified system known as "water's edge combination." In the water's edge system, certain foreign companies, designated "overseas business organizations," are excluded from the combined group notwithstanding that they may otherwise qualify as unitary members. *See* N.H. Rev. Stat. Ann. § 77-A:1, XV and XIX, at Petitioners' App. 42a - 44a. The foreign companies' net income is not included in determining the water's edge group's tax base, and these companies' property, payroll and sales are likewise excluded from the calculation of the water's edge group's apportionment percentage. In effect, these foreign companies are treated as if they were unrelated to the group and intercompany payments, such as royalties and interest, are handled no differently than if they were made by unrelated third parties.[5]

Like any other payment from an unrelated party, royalties and interest received from foreign companies are included in gross receipts before deductions on the recipient's federal income tax return and, thus, flow into the water's edge group's preapportionment tax base. Such payments are also reflected in the group's sales apportionment factor. Since the payor is not domiciled in New Hampshire, the source of the receipt is extraterritorial and is included only in the denominator of the sales factor. The reflection of such payments in the denominator of the sales factor decreases the percentage of the combined group's income that is apportioned to New

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[5] Royalties and interest are not the only intercompany transactions handled this way; so, too, are payments for goods, services, and rents. Certain intercompany distributions of retained earnings, *i.e.*, foreign dividends, are given special treatment by the business profits tax. *See* N.H. Rev. Stat. Ann. § 77-A:3, II(b), at Petitioners' App. 52a. With the filing of their Second Amended Petition, Petitioners abandoned any claim they had with respect to such dividends and elected to pursue only the issue of royalties and interest.

Hampshire. Petitioners' error is that they fail to include these payments at all. The process – calculation of the group's tax base, apportionment percentage, and tax – is demonstrated in Example 4, at App. 14a-15a.

E. Proceedings Below.

Clarification of the Petitioners' description of the proceedings below is necessary for the Court to rule on this Petition. Clarification is needed because the Petition alleges violations of the Due Process and Commerce Clauses that were not heard by the lower courts because the Petitioners abandoned such claims at the trial court level.

At the trial court, the Petitioners based their constitutional claim solely on the third prong of the four prong test of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977): nondiscrimination against interstate (foreign) commerce. However, before this Court, Petitioners are attempting to substantially broaden their claims to encompass alleged violations of the Due Process Clause[6] and the first ("substantial nexus") and second ("fair apportionment") prongs of *Complete Auto*.[7] *See* Petition at 19–22. The issues in this case were framed for the Merrimack County Superior Court in the Petitioners' Second Amended Petition which raised three counts for the court's determination: Count I – Department of Rev-

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[6] "For a state to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: a "minimal connection" between the interstate activities and the taxing state, and a rational relationship between the income attributed to the state and the intrastate values of the enterprise," *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-37 (1990) (citations omitted).

[7] A tax (1) must be applied to an activity with a substantial nexus with the taxing state; (2) must be fairly apportioned; (3) may not discriminate against interstate commerce; and (4) must be fairly related to the services provided by the state. *Complete Auto*, 430 U.S. at 287.

enue Administration's actions discriminate against foreign commerce; Count II – statutory request for modification of the formula; and Count III – violation of 42 U.S.C. 1983.

Although Petitioners attempt to slide into their "fair apportionment," "substantial nexus," and Due Process claims through their facial discrimination argument, these claims were never raised at the trial court level and this Court should not entertain them here.

Finally, in the New Hampshire Supreme Court, Petitioners strenuously argued that royalties and interest received from foreign subsidiaries are actually "repatriations" of "income earned" by those foreign companies, *i.e.*, dividend substitutions. That argument was belied by the Stipulation of Facts which states that Caterpillar and other of its domestic subsidiaries licensed intangible or intellectual property or loaned money to such companies. *See* Stip. ¶ 10, at App. 2a. This argument, while not openly expressed in the Petition, appears to be assumed. Petitioners have "assumed" this characterization of royalties and interest received from foreign subsidiaries because the "repatriation" notion is fundamental to the logic through which Petitioners construct their argument for discriminatory treatment. That characterization is not supported by the facts in this case, nor is it established by law. And, since Petitioners appear to have abandoned their "repatriation" argument, they are barred from raising it now.

REASONS FOR DENYING THE PETITION

I. The Petition Should Be Denied As *Certiorari* Was Denied On This Identical Question.

The essence of the Petition is that the New Hampshire Supreme Court misapplied Footnote 23 of *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505

U.S. 71, 80 (1992), and did not apply the proper test to determine whether there is impermissible discrimination under the Foreign Commerce Clause. The Petition should be denied as this identical issue was submitted to this Court by Petitioner Caterpillar against the State of Minnesota and *certiorari* was denied in that case. *See Caterpillar, Inc. v. Commissioner of Revenue*, 568 N.W.2d 695 (Minn. 1997), *cert. denied*, 118 S. Ct. 1043 (1998) ("*Caterpillar (Minn.)*").

The Minnesota Franchise Tax and New Hampshire's Business Profits Tax are, in relevant part, the same. Both require only unitary domestic subsidiaries' net incomes and apportionment factors to be combined; foreign subsidiaries or affiliates, unitary or not, are treated as if they were unrelated persons.[8] *Caterpillar (Minn.)*, 568 N.W.2d at 699. The Minnesota court found that the state's water's edge system did not "facially discriminate or unduly burden foreign commerce." *Id.* at 701. In so doing, it distinguished the holding in *Kraft*:

> *Kraft* was a relatively easy case for the [U.S. Supreme] Court to decide because Iowa used a separate entity reporting method, . . . thus, the Court could directly compare Iowa's treatment of dividends received from two separate entities, i.e., the domestic subsidiary and the foreign subsidiary. However, in this case, we are concerned with *combined* reporting, not single entity reporting, and

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[8] New Hampshire's sales apportionment provisions do differ slightly from Minnesota's. In Minnesota, the amount of the royalties and interest received from unitary foreign subsidiaries or unrelated foreign or domestic payors is not included in the sales factor. Only sales of tangible property are used to measure sales activity. *See* Minn. Stat. § 290.19. In New Hampshire such amounts are always included in the denominator of the sales factor. *See* N.H. Rev. Stat. Ann. § 77-A:3, I(c), at Petitioners' App. 53a; and Example 4, at App. 14a-15a. That difference does not in any way affect the applicability of the Minnesota decision to this case.

> thus must look at the entire apportionment formula rather than simply the treatment of interest and royalties.

Id. at 701 (emphasis in the original; citations omitted).

When Petitioner Caterpillar challenged the Minnesota Supreme Court's ruling on the identical issue raised in this Petition, this Court denied review. There have been no intervening decisions that have created a conflict among the state courts since this Court denied review of the Minnesota Supreme Court's ruling. Thus, this Court should deny review in this case.

II. Petitioners Failed To Establish That The New Hampshire Business Profits Tax Facially Discriminates Against Foreign Commerce In Violation Of The Foreign Commerce Clause.

Petitioners allege that the Business Profits Tax facially discriminates against foreign commerce. Petitioners' claim rests entirely upon the non-discrimination component of Foreign Commerce Clause jurisprudence. Petitioners however do not apply the standards established by this Court to determine whether a tax discriminates against foreign commerce. The court below did apply the proper standards and correctly determined that Petitioners did not show that discrimination exists.

A. The Established Standards.

The non-discrimination component of Foreign Commerce Clause jurisprudence has been recently considered and applied in *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298, 310-11 (1994) (citing *Complete Auto*, 430 U.S. at 279). The non-discrimination component prohibits "taxes that pass an unfair share of the tax burden onto interstate [foreign] commerce," *Quill Corp. v. North Dakota*, 504 U.S. 298, 313

(1992), or taxes that "systematically 'overtax[ ]' foreign corporation." *Barclays*, 512 U.S. at 314. A law is discriminatory if it taxes interstate commerce more heavily than intrastate commerce, *see Armco, Inc. v. Hardesty*, 467 U.S. 638, 642 (1984), or foreign commerce more heavily than domestic commerce, *see Kraft*, 505 U.S. at 79-80.

In determining whether foreign commerce is more heavily taxed, a court must consider "the operation of other provisions of the . . . statute" under review. *Kraft*, 505 U.S. at 80-81 (quoting *amicus* brief of the United States with approval); *see also Maryland v. Louisiana*, 451 U.S. 725, 756 (1981) (a tax must be evaluated in light of the other provisions of the tax scheme). Further, this Court has specifically stated that the correct comparison to be made in cases like this one is between taxpayers who are the "most similarly situated." *See Kraft*, 505 U.S. at 80 n.23.

Finally, the burden of showing that foreign commerce is more heavily taxed is on the party claiming discrimination. *See Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979); *Norton Co. v. Department of Revenue*, 340 U.S. 534, 537 (1951) (taxpayer claiming constitutional immunity from tax has burden of establishing it).

This Court's standards are well-established and have been recently considered and applied by this Court. There is no need to revisit them.

B. The New Hampshire Supreme Court Applied The Standards Established By This Court And Correctly Held That Petitioners Did Not Show That Facial Discrimination Exists.

The New Hampshire Supreme Court correctly determined that Petitioners did not show that discrimination exists. *Caterpillar (N.H.)*, at Petitioners' App. 13a. The New Hampshire

Supreme Court compared the Business Profits Tax imposed upon the foreign members of the unitary group and unrelated domestic entities. *Caterpillar (N.H.)*, at Petitioners' App. 10a. It considered "the operation of other provisions of the . . . statute" under review. *Caterpillar (N.H.)*, at Petitioners' App. 5a –6a, 10a – 11a. It also imposed upon Petitioners the burden of showing that foreign commerce is more heavily taxed than domestic commerce. *Caterpillar (N.H.)*, at Petitioners' App. 8a.

Following the decisions of this Court, the New Hampshire Supreme Court correctly considered all of the provisions of the Business Profits Tax. It considered that New Hampshire completely excludes the income of foreign subsidiaries from the combined group's apportionable tax base, thus reducing the tax base and ensuring that none of the income recorded on the books of a foreign subsidiary is apportioned to New Hampshire.[9] This lower tax base lowers the New Hampshire tax.

When all of the provisions of the Business Profits Tax are taken into account, Petitioners cannot show facial discrimination. While the exclusion of a foreign subsidiary's factors increase the tax, the exclusion of its net income from the tax base decreases the tax. When both the apportionment formula and the entire tax base are considered, it is not possible to establish that the Business Profits Tax will be.

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[9] The New Hampshire Supreme Court observed that Petitioners are taxed with respect to the royalties and interest received from their foreign subsidiaries just as they are taxed on any royalties and interest that they may receive from unrelated corporations. Petitioners' App. 10a - 11a. This identical treatment is significant because it shows that New Hampshire's Business Profits Tax is structured to avoid taxing the income of foreign subsidiaries. Just as New Hampshire's tax is structured to tax Petitioners only for Petitioners' income and not for income of unrelated corporations which make payments to Petitioners, New Hampshire's tax is structured to similarly avoid taxing Petitioners for the income of their foreign subsidiaries.

higher for a parent corporation with a foreign subsidiary than for a parent corporation with a domestic subsidiary. A parent corporation with a foreign subsidiary may pay more or less tax than a parent with a domestic subsidiary. Whether the tax is higher depends on many independent facts including: the income of the parent; the income of the subsidiary; the property, payroll and sales factors of the parent; the property, payroll and sales factors of the subsidiary; the amount of royalties and interest paid by the subsidiary to the parent; and the nature and amounts of other transactions between the parent and subsidiary. Whether the tax will be higher or lower for a parent with a foreign subsidiary depends on which of the infinite combinations of these elements is present in a particular case. *Caterpillar (N.H.)*, at Petitioners' App. 13a (citing *ASARCO Inc. v Idaho State Tax Comm'n*, 458 U.S. 307, 326-27 n.22 (1982)) (application of unitary-business principle is fact-specific). The fact that the tax may be higher or lower shows that the Business Profits Tax does not discriminate against foreign commerce.

Petitioners use a single example to illustrate their claim that New Hampshire's water's edge combination method of taxation discriminates against foreign royalties and interest. *See* Petition at 16-17. In their example, Petitioners first focus on the royalty and interest payments as separate items and then reclassify them as "Foreign Unitary Income" so that they have the appearance of comparability with the combined net incomes of Caterpillar's domestic subsidiaries. Petitioners then argue that a greater percentage of the foreign royalty and interest payments are taxed under the water's edge system. This attempt to isolate the payments of royalties and interest, and then argue that the apportionment factors will always be higher for the group with the foreign members, ignores the amount of income that is excluded from the tax base.

The operation of the entire Business Profits Tax statute on a water's edge group that receives royalties and interest paid

by a foreign subsidiary demonstrates that the treatment is neutral and nondiscriminatory. This different, nondiscriminatory treatment of a water's edge combination of a parent with a domestic subsidiary and a parent with an uncombined foreign subsidiary is explained in Examples 3 and 4 respectively. App. 12a-15a. The Appendix to this Brief contains additional examples, using perfectly plausible numbers, in which a group with a foreign subsidiary would pay less tax to New Hampshire than would an identical group with only domestic members. *See* App. 16a-21a. These examples further demonstrate that income and expenses of the foreign companies are excluded from the tax base and that only the factors of those companies whose income and expenses are included in the tax base are included in the calculation of the apportionment percentage. This is a neutral, logical, and symmetrical method of computing taxable income.

As they did in the court below, Petitioners fail to consider the operation of the entire Business Profits Tax statute in their analysis. Petitioners focus on the apportionment formula and a portion of the tax base, but only that portion which exists for companies receiving payments from foreign subsidiaries. No valid comparison between companies with foreign subsidiaries and companies with domestic subsidiaries is even possible as there is no comparable portion of the tax base for payments from companies with domestic subsidiaries. While in some cases a parent corporation's apportionment percentage is lower when the parent has a domestic subsidiary than when it has a foreign subsidiary, Petitioners' analysis is incomplete and incorrect because Petitioners only apply these percentages to the amount of any royalties and interest received from the subsidiaries.

Petitioners' analysis is contrary to the decisions of this Court due to their failure to consider the entire Business Profits Tax statute. *See Kraft*, 505 U.S. at 80-81; *Maryland v. Louisiana*, 451 U.S. at 756. Specifically, Petitioners fail to consider that

while the apportionment percentage is higher when a subsidiary is foreign, the apportionable tax base is lower because the income of the foreign subsidiary is excluded from the apportionable tax base of the combined group.

Review of the decision below is not necessary because the New Hampshire Supreme Court applied the standards established by this Court and correctly held that Petitioners did not show that discrimination exists.

C. Petitioners' Arguments Are Based On The Flawed Premise That All Payments From Foreign Subsidiaries To Members Of The Water's Edge Group Are Made Because Of The Group's Ownership And Control Of Those Subsidiaries.

Petitioners contend that, without "factor representation," the water's edge method employed in the Business Profits Tax facially discriminates against royalties and interest received from unitary foreign subsidiaries in violation of the Foreign Commerce Clause of the United States Constitution. The tax discriminates against foreign commerce, allege Petitioners, because royalty and interest received from unitary domestic subsidiaries is treated more favorably. At the New Hampshire Supreme Court, the Petitioners asserted that the cure to the problem was to include the foreign royalty and interest payor's property, payroll and sales in the water's edge groups' apportionment factor denominators to accurately reflect – in Petitioners' view – the "source" of the income.[10]

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[10] In their Petition, it now appears that Petitioners are asserting that there should be total exclusion of foreign royalty and interest payments from the water's edge group. This was their theory at the trial court level. However, they abandoned that argument at the New Hampshire Supreme Court and should not be allowed to raise it in this Petition. *See* Petition at 18-19.

1. There Is No Factual Basis In The Record For Petitioners' Assertion That Royalty And Interest Payments Repatriate Unitary Income From Its Foreign Subsidiaries.

As noted in the Statement of Case, the factual foundation of this case is an agreed Stipulation of Facts. Nowhere in the Stipulation is it provided that royalty and interest payments from Petitioners' foreign subsidiaries actually constituted a form of distribution of the payor subsidiary's earned income. Indeed, the only controlling facts in the Stipulation concerning the nature of these payments is that the royalties were paid in exchange for licenses to use intellectual property, i.e., trademarks and technology, and that the interest paid was for intercompany loans. *See* Stip. ¶ 10, at App. 2a. The Stipulation actually supports the contrary characterization of those payments: they are the result of contractual obligations neither tied to nor dependent upon any notion of net income of the payor.

Caterpillar made similar statements to the Minnesota Supreme Court. The Minnesota Supreme Court rejected Caterpillar's attempt to recharacterize its intercompany interest and royalty payments as anything other than contractual obligations. *Caterpillar (Minn.)*, 568 N.W.2d at 696 n.6. As a result, the essential factual foundation to Petitioners' arguments in this case is missing.

2. There Is No Basis In Law For Petitioners' Assumption That Royalty And Interest Payments Have The Same Character As Dividends.

As noted previously, Petitioners argued to the New Hampshire Supreme Court that royalty and interest payments have the same character as dividends. While this argument is not clearly articulated in this Petition, it is certainly assumed. It is an assumption that this Court should reject.

"Royalty" is defined as a "a payment reserved by the grantor of a patent, lease of mine or similar right, and payable proportionally to the use made of the right by the grantee." *Black's Law Dictionary,* at 1496 (4th ed. 1968). It also means "a payment which is made to an author or composer by an assignee or licensee in respect to each copy of his work which is sold, or to an inventor in respect of each article sold under the patent." *Id.* "Interest" means "the compensation allowed by law or fixed by the parties for the use or forbearance or detention of money." *Id.* at 950. By common definition, then, royalties and interest are derived from contractual arrangement between the payor and the payee whereby the payor has the right to use certain property of the payee: intellectual property such as patents, trademarks, and licensed technology with respect to royalties; money or credits with respect to interest.

Under generally accepted accounting principles, royalties received represent revenue to the recipient and royalties paid expenses of the payor. *See* Donald E. Kieso and Jerry J. Weygandt, *Intermediate Accounting*, 568, 570, 572 (4th ed. 1983). Similar treatment is accorded to interest received and paid. Under federal income tax law, royalty and interest payments are expense deductions from gross revenues for the payor, 26 U.S.C. § 162, 163, and revenue items included in the gross income of the payee, 26 U.S.C § 61. The net effect of a payment of royalties or interest, regardless of whether the payor is related to the payee, is reduction of the payor's income and increase of the payee's.

Petitioners' previously open and now assumed mischaracterization of these payments as something other than contractual consideration is an attempt to force them into a role comparable to the net income of the domestic subsidiaries included in a water's edge combined return.

This mischaracterization does not consider that the royalties and interest received by Petitioners are income of the

combined group and it is the income of the combined group that is being measured, apportioned and taxed. When paid by the foreign subsidiary, the royalties and interest are not income of the subsidiary. Rather, they are expenses of the foreign subsidiary which reduce its income.

The New Hampshire Supreme Court correctly rejected the Petitioners' mischaracterization of the royalty and interest payments as income of the foreign-payors. The court properly determined the payments to be income of the domestic recipients. *Caterpillar (N.H.)*, at Petitioners' App. 11a – 12a. *Accord Caterpillar (Minn.)*, 568 N.W.2d at 696 n.6; *Caterpillar Financial Services Corp. v. Whitley*, 680 N.E.2d 1082 (Ill. Ct. App.), *appeal denied*, 686 N.E.2d 1158 (Ill. 1997).

The court below did not err and review is unwarranted.

III. The New Hampshire Supreme Court's Decision Does Not Conflict With Decisions Of Other State Appellate Courts.

There is no conflict among the lower courts, despite Petitioners' assertions to the contrary. The lower courts have all interpreted the *Kraft* decision the same way. The New Hampshire Supreme Court was only the most recent to issue its interpretation. The cases where lower courts have struck state taxes as discriminating against foreign commerce all involved tax systems that did not require combined reporting. *See Conoco, Inc. v. Taxation & Revenue Department*, 931 P.2d 730 (N.M. 1996) (holding that *Kraft* discrimination is not remedied by factor expansion), *cert. denied*, 117 S. Ct. 2497 (1997); *Dart Industries, Inc. v. Clark*, 657 A.2d 1062 (R.I. 1995) (statute indistinguishable from *Kraft*).

Since New Hampshire uses combined reporting, it does not discriminate. And, all state appellate courts that have reviewed this issue have held that water's edge combination systems do not discriminate against payments from foreign

sources. *See Caterpillar (Minn.)*, 568 N.W.2d at 701 (holding that Minnesota's water's edge system did not facially discriminate or unduly burden foreign commerce); *Caterpillar Fin. Servs. Corp. v. Whitley*, 680 N.E.2d 1082 (Ill. Ct. App.), *appeal denied*, 686 N.E.2d 1158 (Ill. 1997) (tax does not discriminate against royalties and interest from foreign subsidiaries where the total net income of domestic subsidiaries is include in apportionable income while the total net income of foreign subsidiaries is excluded); *E. I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996) (holding Maine's water's edge combined reporting method does not discriminate against dividends from foreign subsidiaries); *In re Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993) (Kansas' water's edge combined reporting method does not facially discriminate against dividends from foreign subsidiaries).

In deciding this case, the court below correctly applied this Court's standards for determining discrimination under the Foreign Commerce Clause and the decisions of other state appellate courts are consistent with it.

IV. New Hampshire's Non-Discriminatory, But Different, Accounting For Foreign And Domestic Subsidiaries Is Justified.

Considering all of Petitioners' arguments, their protestations to the contrary notwithstanding, it is apparent that the real challenge is to the use of water's edge combination rather than worldwide combination. The logical consequence of Petitioners' arguments would be the adoption of worldwide combination – all unitary entities would then be combined. However, there are sound policy reasons why the federal government pressured the states into abandoning worldwide combination.

Combined reporting of corporate income was not the norm in New Hampshire or anywhere until relatively recently. The

constitutionality of combination came to this Court from the State of California and, in 1983, this Court ruled that California's use of worldwide combination and apportionment did not violate the Due Process and Commerce Clauses of the United States Constitution. *See Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). The Court stated that it has "long held that the Constitution imposes no single formula on the States" because precise territorial allocation of the income of a unitary business enterprise "is often an elusive goal, both in theory and practice." *Container*, 463 U.S. at 164.

Although worldwide combination and apportionment was held constitutional, courts, commentators, governments, and business have all recognized that the use of worldwide combination presents substantial problems. For example, worldwide combination combines the income and factors of both domestic and foreign corporations, including foreign corporations that are not required to report their activities on federal tax returns because they are beyond the reach of the taxing power of the United States. *See Container*, 463 U.S. at 184; 26 U.S.C. §§ 881-885. It thus presents a basic compliance problem. In addition, worldwide combination necessitates converting the diverse languages, currency, and accounting principles from around the world into the language, currency, and accounting principles of the United States, a substantial burden on taxpayers and the states. *See Barclays*, 512 U.S. at 313. Further, worldwide combination conflicts with the separate entity accounting system that the United States and foreign nations use for foreign corporations. *See Container*, 463 U.S. at 184. The use of worldwide combination by states has been opposed by virtually every developed country in the world, *see Barclays*, 512 U.S. at 324-25 n.22, and the states have been pressured not to employ it.

Under pressure from multinational companies and under the threat of federal legislation, states that previously adopted

worldwide combination and apportionment began to move away from it after the *Container* decision. Noted tax commentators have described this reaction:

> In an ironic twist of history, the victory of the California Franchise Tax Board in the *Container* worldwide apportionment case led to the demise of worldwide apportionment in some States and to its restriction in other States. The ink was hardly dry on the *Container* decision in 1983 when President Ronald Reagan responded to the relentless pressure of multinational enterprises, supported by foreign governments, by convening a Worldwide Unitary Taxation Working Group to review worldwide apportionment. In its 1984 report, the Working Group recommended the adoption by the States of legislation or administrative action that would limit unitary apportionment of both U.S. and foreign-based multinationals to U.S. waters edge income. In the event "there are not sufficient signs of appreciable progress by the States" in adopting the agreed principles, Secretary of the Treasury Donald Regan stated that he would recommend Federal legislation that "would give effect to a water's edge limitation."

1 Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, ¶ 8.16, at 8-185 (2nd ed. 1993) (footnotes deleted). Acting with "unusual legislative speed," states changed their laws to adopt some form of water's edge apportionment. *Id.* ¶ 8.16, at 8-185, 8-187. And, as the New Hampshire Supreme Court noted, "the water's edge method was adopted for the benefit of foreign businesses." *Caterpillar (N.H.)*, at Petitioners' App. 11a. Except for Alaska's special provision for oil, gas and pipeline companies operating there, no state requires worldwide unitary reporting. CCH State Tax Guide, vol. 1, ¶ 10-115 (3/97); CCH State Tax Reporter, Alaska, ¶ 12-404 (9/96).

The foregoing shows that strong policies and state interests justify the use of the water's edge combination method.

CONCLUSION

Based on the reasons set forth above, the State of New Hampshire Department of Revenue Administration and Stanley R. Arnold, Jr., the New Hampshire Commissioner of Revenue, respectfully request that this honorable Court deny the Petition for Writ of *Certiorari*.

Respectfully submitted,

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION AND STANLEY R. ARNOLD, COMMISSIONER

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February 22, 2000

No. 99-1214

IN THE

Supreme Court of the United States

CATERPILLAR INC., CATERPILLAR FINANCIAL SERVICES CORPORATION, AND SOLAR TURBINES INCORPORATED,

Petitioners,

v.

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION AND STANLEY R. ARNOLD, JR., THE N.H. COMMISSIONER OF REVENUE,

Respondents.

APPENDICES

APPENDIX A

IN THE STATE OF NEW HAMPSHIRE

MERRIMACK, SS. JULY TERM, 1995

SUPERIOR COURT

93-E-609-B

CATERPILLAR INC., ET AL.,

Petitioners,

v.

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION
AND STANLEY R. ARNOLD, JR.,
THE NEW HAMPSHIRE COMMISSIONER OF REVENUE

Respondents.

STIPULATION OF FACTS

It is hereby stipulated that for purposes of this case the following statements are accepted as fact and all exhibits referred to herein are incorporated in this Stipulation and made a part hereof; provided, however, that the parties may introduce other and further evidence not inconsistent with the facts herein stipulated, and provided further, that either party may object to any of the facts or documents herein on the grounds of materiality or relevancy. All other evidentiary objections are waived unless specifically expressed in this Stipulation. Unless the context

D. Unitary Intragroup Transactions

10. Caterpillar Inc. and certain other domestic members license their trademarks and technology in return for royalty payments, and provide intercompany loans, to foreign and domestic members of the Caterpillar Unitary Group.

11. In 1987, the following foreign members of the Caterpillar Unitary Group paid royalties and interest income to certain members of the 1987 Water's Edge Group in the following amounts:

FOREIGN MEMBER	ROYALTIES PAID	INTEREST PAID
Caterpillar Africa	$ 522,347	$ 175,039
Caterpillar Australia	808,429	2,170,318
Caterpillar Belgium	34,926,845	21,103
Caterpillar Brasil	0	2,256,621
Caterpillar Canada	6,094,516	323,933
Caterpillar China	0	0
Caterpillar Commercial N.V.	0	4,811
Caterpillar Far East	0	16,443
Caterpillar Financial Services N.V.	0	281,255
Caterpillar France	11,641,155	984,298
Caterpillar U.K. Ltd.	21,401,511	120,235
Caterpillar Overseas S.A.	4,677,895	241,676
Conek	366,808	2,357,790
P.T. Natra Raya	637,493	256,040
Solar Turbines Canada	0	52,002
Solar Turbines S.A.	0	0

These taxes were imposed by the foreign governments of the countries in which the foreign members of the Caterpillar Unitary Group (as defined in ¶ 3) were located. The withholding taxes paid with respect to the receipt of royalties and interest were paid by the members of the Water's Edge Group to the foreign governments. U.S. Federal law provides a foreign tax credit for foreign withholding taxes paid directly by the members of the Water's Edge Group. New Hampshire law does not provide a foreign tax credit for foreign withholding taxes paid. The withholding tax payments were not reported on the foreign income tax returns of the foreign members of the Caterpillar Unitary Group because these payments were made by the members of the Water's Edge Group. For Federal tax purposes, all of the members of the Water's Edge Group receiving payments elected to take a credit in respect of the foreign withholding taxes paid rather than a deduction.

15. Interest and royalties received by members of the Water's Edge Group were deducted on the foreign income tax return of the foreign member of the Caterpillar Unitary Group making the payment. On the federal income tax return of the member of the Water's Edge Group receiving the royalty and interest income, these amounts are treated as foreign source income. These amounts were included in the figure shown on Line 28 on the federal income tax return. New Hampshire uses Line 28 of the federal return to begin its calculations. These amounts are not subsequently eliminated on

the New Hampshire return. These amounts received are included in the New Hampshire apportionable income of the Petitioners.

16. In 1987, 1988 and 1989 members of the Water's Edge Group made interest payments to Caterpillar Inc. in the amounts of $10,910,515, $17,833,229 and $22,444,857, respectively.

E. Calculation of New Hampshire Business Profits Tax Liability

17. In each of the 1987, 1988 and 1989 tax years, New Hampshire law required the Water's Edge Group to calculate its New Hampshire BPT liability pursuant to the following, bifurcated process:

Step 1. Calculating New Hampshire's Water's Edge Taxable Business Profits

A. The federal taxable incomes (before net operating losses and other special deductions) of each of the Water's Edge Group members, less foreign dividends and Subpart F income (certain income earned by foreign subsidiaries that is treated as if earned directly by the U.S. parent), are combined to produce "New Hampshire Combined Net Income." All intragroup payments received by a Water's Edge Group member from other Water's Edge Group members (including interest and royalty payments, if any) are eliminated in making this calculation (i.e., such payments are treated as if they had not been made). Payments, including interest and royalty payments, received by a Water's Edge Group member from foreign members of the Caterpillar Unitary Group and

of any audit adjustments by the Internal Revenue Service which are agreed or finally upheld in an administrative or court proceeding.

Respectfully submitted,

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July 19, 1995

APPENDIX B

NEW HAMPSHIRE REVISED STATUTES ANNOTATED

TITLE V. TAXATION
CHAPTER 77-A. BUSINESS PROFITS TAX

RSA 77-A:6 (1996)

77-A:6. Returns, Declarations, and Combined Reporting.

I. Every business organization having gross business income in excess of $50,000 as defined by RSA 77-A:1, VI, during the taxable period, shall on or before the fifteenth day of the third month in the case of organizations required to file a United States corporation tax return, and the fifteenth day of the fourth month in the case of all other business organizations, following expiration of its taxable period, make a return to the commissioner. The commissioner of revenue administration shall adopt rules, pursuant to RSA 541-A, relative to the form of such return and the data which it must contain for the correct computation of taxable business profits and gross business income attributable to this state and the tax assessed on it. All returns shall be signed by the taxpayer or by its authorized representative, subject to the pains and penalties of perjury.

II. Every business organization shall in addition file a declaration of its estimated business profits tax for its subsequent taxable period; provided, however, if the estimated tax is less than $200, a declaration need not be filed; and provided further that a declaration shall be filed at the end of any quarter thereafter in which estimated tax exceeds $200. The declaration shall be filed when payments are due under RSA 77-A:7.

III. [Repealed]

IV. A business organization which is part of a water's edge combined group and required to report under this chapter shall file a return containing the combined net income of the water's edge combined group and such other informational returns as the commissioner shall require by rules adopted under RSA 541-A. The commissioner is authorized to impose the tax as though the entire combined net income of the water's edge combined group was that of one business organization or the commissioner may adjust the tax or income in such other manner as the commissioner shall determine to be equitable if the commissioner determines it to be necessary in order to clearly reflect the net income earned by such organization from business done in this state. This provision shall not authorize the application of worldwide combined reporting except as provided in RSA 77-A:2-b, II.

HISTORY: SOURCE. 1970, 5:1. 1971, 515:6. 1973, 544:9; 579:1, 4, 5. 1975, 166:1; 439:34, 36. 1977, 593:3, 4; 605:1. 1981, 128:17; 445:8, 568:65, I. 1986, 153:6. 1991, 163:43, IX. 1993, 202:1, eff. July 1, 1993. 1996, 154:3, eff. July 1, 1996.

AMENDMENTS --1996. Paragraph IV: Substituted "the commissioner" for "he" in three places in the second sentence.

--1993. Paragraph I: Substituted "$50,000" for "$12,000" in the first sentence.

--1991. Paragraph III: Repealed.

--1986. Paragraph IV: Amended generally.

--1981. Paragraph I: Chapter 128 deleted "under such regulations and in such form or manner as the commissioner may prescribe" following "return to the commissioner" in the first sentence and rewrote the second sentence.

Chapter 445 inserted "and gross business income attributable to this state" following "business profits" in the second sentence.

Chapter 568 substituted "$12,000" for "$6,000" in the first sentence.

Paragraph II: Chapter 445 deleted "at the same time the return is filed as required by paragraph I" preceding "every business", "estimated taxable business profits and" following "declaration of" and inserted "and" preceding "provided further" in the first sentence, rewrote the second sentence and made minor changes in punctuation throughout the paragraph.

Paragraph III: Added by ch. 445.

Paragraph IV: Amended generally by ch. 445.

--1977. Paragraph I: Chapter 605 inserted "in the case of organizations required to file a U.S. corporation tax return and the fifteenth day of the fourth month in the case of all other business organizations" preceding "following expiration" in the first sentence.

Chapter 593:3 substituted "fifteenth day of the third month" for "the first day of the fifth month" in the first sentence.

Paragraph IV: Chapter 593:4 substituted "thirtieth" for "fifteenth" preceding "day".

--1975. Paragraph II: Chapter 166 added the two provisos at the end of the first sentence.

Chapter 439:36 deleted "unless for good cause the commissioner permits the taxpayer to make a lesser estimate" following "therewith" in the second sentence.

Paragraph III: Repealed by ch. 439:34.

--1973. Chapter 544 substituted "commissioner" for "commission" wherever it appeared in pars. I-III.

Chapter 579 deleted "commencing July 1, 1970" preceding "every business organization" and added "having gross business income in excess of six thousand dollars as defined by RSA 77-A:1, VI, during the taxable period" thereafter in the first sentence of par. I, added the second sentence of par. II and added par. IV.

--1971. Paragraph II: Deleted "except those anticipating a gross business profit of less than ten thousand dollars during its subsequent taxable period" following "organization" in the first sentence.

Paragraph III: Added.

Applicability of 1993 amendment. 1993, 202:2, eff. July 1, 1993, provided that section 1 of the act, which amended par. I of this section, shall apply to returns and taxes due on account of taxable periods ending after June 30, 1993.

Applicability of 1986. 1986, 153:9, provided that 1986, 153:6, would apply to returns and taxes due on account of taxable periods beginning after June 30, 1986.

Purpose of 1986 amendment. 1986, 153:1, provided: "This act amends existing law by limiting the application of the business profits tax to the water's edge by eliminating overseas business organizations from subjection to this tax. However, it is not the intent of this legislation to alter those basic premises of New Hampshire taxation policies which follow the federal method of calculating taxable income, particularly when such policies or procedures are intended to further New Hampshire concerns with equal and proportional treatment of taxpayers."

APPENDIX C

Calculating New Hampshire Business Profits Tax

TAX BASE:

federal taxable income ± state adjustments = adjusted gross business profits

APPORTIONMENT:

NH property everywhere / property	+	NH payroll everywhere / payroll	+	NH sales everywhere / sales	+	3

= apportionment percentage

TAX CALCULATION:

adjusted gross business profits X apportionment percentage = taxable business profits

taxable business profits X tax rate = tax

Example 1
(Separate Entity Accounting and Apportionment)

Separate entity accounting is the way most businesses file their New Hampshire Business Profits Tax returns, becuase most filers are not part of a larger unitary group. If the business operates only in New Hampshire, calculation of the tax is easy. Net income, as adjusted, is multiplied by the tax rate to determine the tax. If the company operates in more than one state, however, apportionment is required.

Assume company P has total sales of $150,000 and expenses of $120,000 (net income of $30,000), with property, payroll, and sales in New Hampshire of $500, $1,000, and $5,000, respectively, compared to total property, payroll, and sales of $40,000, $20,000, and $150,000, respectively. P's tax base would be its $30,000 net income. Its apportionment percentage would be calculated as follows:

APPORTIONMENT PERCENTAGE:

Property: NH	500
Everywhere	40,000
Payroll: NH	1,000
Everywhere	20,000
Sales: NH	5,000
Everywhere	150,000

Percentage Calculation:	Property	500/40,000	=	1.2500%
	Payroll	1,000/20,000	=	5.0000%
	Sales	5,000/150,000	=	3.3333%
	Average (total % divided by 3)			3.1944%

TAX CALCULATION:

Net Income	X	Apportionment %	=	Taxable Profits
$30,000	X	3.1944%	=	$958.32
Taxable Profits	X	Tax Rate	=	Tax
$958.32	X	8%	=	$76.67

Example 2
(Combined Reporting and Apportionment)

Assume that company P (the same company as in Example 1) has a domestic subsidiary S. They are the only two members of a unitary group. Assume, as above, that P has $150,000 in sales and $120,000 in expenses ($30,000 net income), while S has $7,000 in sales and $5,000 in expenses ($2,000 net income). Calculation of the group's tax base is a simple matter of adding the net income of the two companies: $30,000 plus $2,000, for an aggregate of $32,000.

For calculating the apportionment percentage, assume P has the same factors as above and that S has no property, payroll, or sales in New Hampshire. S has totals of $1,000 in property, $800 in payroll, and $7,000 in sales. The calculation of the group's apportionment percentage and tax would be as follows:

APPORTIONMENT PERCENTAGE

	Parent P	Sub S	Combined
Property: NH	500	0	500
Everywhere	40,000	1,000	41,000
Payroll: NH	1,000	0	1,000
Everywhere	20,000	800	20,800
Sales: NH	5,000	0	5,000
Everywhere	150,000	7,000	157,000

Percentage Calculation:	Property	500/41,000	=	1.2195%
	Payroll	1000/20,800	=	4.8077%
	Sales	5,000/157,000	=	3.1847%
	Average (total % divided by 3)			3.0706%

TAX CALCULATION

Combined Net Income	X	Apportionment %	=	Taxable Profits
$32,000	X	3.0706%	=	$982.60

Taxable Profits	X	Tax Rate	=	Tax
$982.60	X	8%	=	$78.61

Example 3
(Combination with Intra-Group Interest Payments)

The effect of an intra-group payment of interest or royalties can be seen by modifying the previous example by having Subsidiary S make a $500 interest payment to Parent P. The combined group's tax base does not change from the previous example. The $500 interest payment is a receipt by P and a corresponding expense deductible by S, so the net income of the group is the same.

Calculation of the apportionment percentage also does not change, but an adjustment must be made to avoid a miscalculation. Because the calculation of the sales factor uses gross receipts, not net profits, the sales factor figures would be overstated unless the $500 interest payment were backed out of the calculation—"eliminated" in the parlance of taxation. The calculation of the group's tax base, apportionment percentage, and tax is as follows:

	Parent P	Sub S	Elimination	Combined
TAX BASE:				
Receipts:				
Net Sales	150,000	7,000		157,000
Interest	500			500
Total	150,500	7,000		157,500
Deductions:				
Other Expenses	(120,000)	(5,000)		(125,000)
Interest		(500)		(500)
Net Income	30,500	1,500		32,000
APPORTIONMENT PERCENTAGE:				
Property: NH	500	0		500
Everywhere	40,000	1,000		41,000
Payroll: NH	1,000	0		1,000
Everywhere	20,000	800		20,800
Sales: NH	5,000	0		5,000
Everywhere	150,500	7,000	(500)	157,000

Percentage Calculation:				
	Property	500/41,000	=	1.2195%
	Payroll	1,000/20,800	=	4.8077%
	Sales	5,000/157,000	=	3.1847%
	Average (total % divided by 3)			3.0706%

TAX CALCULATION:

Combined Net Income	X	Apportionment %	=	Taxable Profits
$32,000	X	3.0706%	=	$982.60

Taxable Profits	X	Tax Rate	=	Tax
$982.60	X	8%	=	$78.61

Example 4
(Water's Edge Combination)

When foreign corporations are included in a conglomerate, international politics can affect the way states levy taxes. One way to determine income that can be taxed by a particular state is separate entity accounting and apportionment as in Example 1 above. Most states, however, require combined reporting. Worldwide combination would be exactly the same as Examples 2 and 3. Water's edge combination is a variant of worldwide combination.

Under water's edge apportionment, all members of a unitary group are combined except those that qualify as "overseas business organizations" under RSA 77-A:1, XV, i.e., foreign businesses. The unitary ties between overseas business organizations and the water's edge members of the unitary group are ignored for purposes of determining the water's edge group's taxable income. The foreign companies' income is not included in determining the water's edge group's tax base, and the foreign companies' property, payroll, and sales are likewise excluded from the calculation of the water's edge group's apportionment percentage. Royalty and interest payments between foreign members and water's edge members are treated as if the foreign members were unrelated to the group.

Therefore, for taxpayers like Caterpillar, such income is included in the water's edge group's tax base and is represented in the denominator of the sales factor in the apportionment percentage—it does not appear in the numerator because the water's edge recipients are not domiciled in New Hampshire. The process can be demonstrated with an example that assumes the subsidiary in the previous example is a foreign corporation and thus not a member of the water's edge group—it is now designated Sub F. The calculation of the group's tax base, apportionment percentage, and tax would be as follows:

	Parent P	Sub F
TAX BASE:		
Receipts:		
Net Sales	150,000	7,000
Interest	500	
Total	150,500	7,000
Deductions:		
Other Expenses	(120,000)	(5,000)
Interest		(500)
Net Income	30,500	1,500
APPORTIONMENT PERCENTAGE:		
Property: NH	500	0
Everywhere	40,000	1,000
Payroll: NH	1,000	0
Everywhere	20,000	800
Sales: NH	5,000	0
Everywhere	150,500	7,000

Percentage Calculation:				
	Property	500/40,000	=	1.2500%
	Payroll	1,000/20,000	=	5.0000%
	Sales	5,000/150,500	=	3.3223%
	Average (total % divided by 3)			3.1908%

TAX CALCULATION:

Combined Net Income	X	Apportionment %	=	Taxable Profits
$30,500	X	3.1908%	=	$973.18

Taxable Profits	X	Tax Rate	=	Tax
$973.18	X	8%	=	$77.85

PARENT WITH COMBINED DOMESTIC SUBSIDIARY

	Parent	Domestic Sub	Elimination	Combined
Tax Base				
Receipts:				
Net Sales	150,000	50,000		200,000
Royalties & Interest	20,000			20,000
Gross Receipts	170,000	50,000		220,000
Deductions:				
Other Expenses	(120,000)	(15,000)		(135,000)
Royalties & Interest		(20,000)		(20,000)
Net Income	50,000	15,000		65,000
Apportionment				
Factors:				
Property : NH	500	0		500
Everywhere	40,000	10,000		50,000
Payroll: NH	1,000	0		1,000
Everywhere	40,000	10,000		50,000
Sales: NH	5,000	0	0	5,000
Everywhere	170,000	50,000	(20,000)	200,000
Percentage Calculation:				
Property %				1.0000%
Payroll %				2.0000%
Sales %				2.5000%
Total (divided by 3)				1.8333%

Tax Calculation

Combined Profits	Apportionment Percentage	Taxable Profits	Tax (at 8%)
65,000	1.8333%	1,191.67	95.33

PARENT WITH UNCOMBINED FOREIGN SUBSIDIARY

	Parent	Foreign Sub
Tax Base		
Receipts:		
Net Sales	150,000	50,000
Royalties & Interest	20,000	
Gross Receipts	170,000	50,000
Deductions:		
Other Expenses	(120,000)	(15,000)
Royalties & Interest	0	(20,000)
Net Income	50,000	15,000
Apportionment		
Factors:		
Property : NH	500	0
Everywhere	40,000	10,000
Payroll: NH	1,000	0
Everywhere	40,000	10,000
Sales: NH	5,000	0
Everywhere	170,000	50,000
Percentage Calculation:		
Property %	1.2500%	
Payroll %	2.5000%	
Sales %	2.9412%	
Total (divided by 3)	2.2304%	

Tax Calculation

Apportionable Profits	Apportionment Percentage	Taxable Profits	Tax (at 8%)
50,000	2.2304%	1,115.20	**89.22**

PARENT WITH COMBINED DOMESTIC SUBSIDIARY

	Parent	Domestic Sub	Elimination	Combined
Tax Base				
Receipts:				
Net Sales	500,000	100,000		600,000
Royalties & Interest	50,000			50,000
Gross Receipts	550,000	100,000		650,000
Deductions:				
Other Expenses	(300,000)	(25,000)		(325,000)
Royalties & Interest		(50,000)		(50,000)
Net Income	250,000	25,000		275,000
Apportionment				
Factors:				
Property : NH	1,000	0		1,000
Everywhere	100,000	10,000		110,000
Payroll: NH	2,500	0		2,500
Everywhere	300,000	10,000		310,000
Sales: NH	5,000	0	0	5,000
Everywhere	550,000	50,000	(50,000)	550,000
Percentage Calculation:				
Property %				0.9091%
Payroll %				0.8065%
Sales %				0.9091%
Total (divided by 3)				0.8749%

Tax Calculation

Combined Profits	Apportionment Percentage	Taxable Profits	Tax (at 8%)
275,000	0.8749%	2,405.91	192.47

PARENT WITH UNCOMBINED FOREIGN SUBSIDIARY

	Parent	Foreign Sub
Tax Base		
Receipts:		
Net Sales	500,000	100,000
Royalties & Interest	50,000	
Gross Receipts	550,000	100,000
Deductions:		
Other Expenses	(300,000)	(25,000)
Royalties & Interest	0	(50,000)
Net Income	250,000	25,000
Apportionment		
Factors:		
Property : NH	1,000	0
Everywhere	100,000	10,000
Payroll: NH	2,500	0
Everywhere	300,000	10,000
Sales: NH	5,000	0
Everywhere	550,000	50,000
Percentage Calculation:		
Property %	1.0000%	
Payroll %	0.8333%	
Sales %	0.9091%	
Total (divided by 3)	0.9141%	

Tax Calculation

Apportionable Profits	Apportionment Percentage	Taxable Profits	Tax (at 8%)
250,000	0.9141%	2,285.35	**182.83**

PARENT WITH COMBINED DOMESTIC SUBSIDIARY

	Parent	Domestic Sub	Elimination	Combined
Tax Base				
Receipts:				
Net Sales	150,000	7,000		157,000
Royalties & Interest	500			500
Gross Receipts	150,500	7,000		157,500
Deductions:				
Other Expenses	(150,000)	(5,000)		(155,000)
Royalties & Interest		(500)		(500)
Net Income	500	1,500		2,000
Apportionment				
Factors:				
Property : NH	500	0		500
Everywhere	25,000	2,000		27,000
Payroll: NH	1,000	0		1,000
Everywhere	30,000	5,000		35,000
Sales: NH	5,000	0	0	5,000
Everywhere	150,500	7,000	(500)	157,000
Percentage Calculation:				
Property %				1.8519%
Payroll %				2.8571%
Sales %				3.1847%
Total (divided by 3)				2.6312%

Tax Calculation

Combined Profits	Apportionment Percentage	Taxable Profits	Tax (at 8%)
2,000	2.6312%	52.62	4.21

PARENT WITH UNCOMBINED FOREIGN SUBSIDIARY

	Parent	Foreign Sub
Tax Base		
Receipts:		
Net Sales	150,000	7,000
Royalties & Interest	500	
Gross Receipts	150,500	7,000
Deductions:		
Other Expenses	(150,000)	(5,000)
Royalties & Interest	0	(500)
Net Income	500	1,500
Apportionment		
Factors:		
Property : NH	500	0
Everywhere	25,000	2,000
Payroll: NH	1,000	0
Everywhere	30,000	5,000
Sales: NH	5,000	0
Everywhere	150,500	7,000
Percentage Calculation:		
Property %	2.0000%	
Payroll %	3.3333%	
Sales %	3.3223%	
Total (divided by 3)	2.8852%	

Tax Calculation

Apportionable Profits	Apportionment Percentage	Taxable Profits	Tax (at 8%)
500	2.8852%	14.43	1.15

(3)

No. 99-1214

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IN THE

Supreme Court of the United States

CATERPILLAR INC.,
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and SOLAR TURBINES INCORPORATED,
Petitioners,

v.

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION and STANLEY R. ARNOLD, JR.,
THE NEW HAMPSHIRE COMMISSIONER OF REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of New Hampshire

BRIEF OF *AMICUS CURIAE* COMMITTEE ON STATE TAXATION IN SUPPORT OF PETITIONERS

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

The Committee On State Taxation (COST) respectfully requests leave to file a Brief as *Amicus Curiae* in support of Petitioners. The interest of COST as *amicus curiae* is described *infra* at Brief, pp. 1-3. Counsel for Petitioners has consented to COST's filing of an *amicus* brief. Despite COST's qualifications to submit an *amicus* brief, Counsel for Respondents has refused to consent to the filing of such a brief. However, in the absence of such

permission there is a compelling reason for granting this request.

This Court should grant COST leave to file its *amicus* brief because COST has additional observations, not fully addressed by Petitioners, to make concerning the constitutional implications of the New Hampshire Business Profits Tax. Specifically, COST discusses why the income at issue being taxed by New Hampshire should not constitutionally be included in the tax base. While Petitioners raised this issue, it is further developed in COST's brief. COST also discusses the discrimination against affiliate capitalization structures resulting from the New Hampshire tax system. This discussion offers an alternative view and analysis of the discrimination against foreign commerce detailed by the Petitioners. Thus, COST's brief gives this Court both additional information and an additional method for analyzing the issues.

Respectfully submitted,

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BRIEF OF *AMICUS CURIAE* COMMITTEE ON STATE TAXATION IN SUPPORT OF PETITIONERS

INTEREST OF *AMICUS CURIAE*

This brief is submitted by the Committee On State Taxation (COST) as *amicus curiae* in support of Petitioners in the above captioned matter.[1] COST's ob-

[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioners has been obtained and filed with the Clerk of the Court.

jective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce and was separately incorporated on January 1, 1992. COST's membership consists of over 500 multistate corporations involved in interstate and international commerce.

COST is submitting this brief because systematic and distortive overcharging by state tax systems, such as the one at issue here, unconstitutionally discriminates against interstate commerce and impedes business's ability to operate in the global economy. New Hampshire has reached beyond its borders to unconstitutionally extract taxes from international business enterprises. *Amicus* hopes that this Court will not allow unconstitutional overcharging to quietly slide into established law and thereby be accepted by taxing authorities in New Hampshire and elsewhere. Such a diminution in taxpayers' constitutional protections threatens the foundations of the state tax system by risking excessive burdens on commerce. COST and its members are concerned that such burdens could become institutionalized elements of state tax systems. Further, New Hampshire's discriminatory method of taxing royalties and interest from foreign affiliates is shared by other states. Thus, not only are COST members with such foreign income unconstitutionally discriminated against in New Hampshire, but they are subject to similar unconstitutional systems in many other states. Thus, COST and its members have a particular interest in seeing the New Hampshire system reviewed (and invalidated) both because of the direct impact on the taxing scheme in New Hampshire and the resulting impact on other, similar state tax schemes. COST and its members request this Court to reiterate and expound upon the constitutional principles

prohibiting the tax on extraterritorial values and the discrimination suffered by Petitioners and many similar taxpayers in New Hampshire and elsewhere.

REASONS FOR GRANTING THE PETITION

COST asks this Court to accept this case to determine that New Hampshire violated the Commerce Clause of the United States Constitution by taxing income with no relation to the state and by taxing income from foreign affiliates differently, and more onerously, than income from domestic affiliates.

First, this case offers this Court the forum to complete its analysis as to what constitutes an unconstitutional tax on extraterritorial values [2] and, more imporantly, to offer the state taxing jurisdictions a template to prevent future violations. While this Court has frequently stated that a state may not tax extraterritorial values, it has not previously had the opportunity to announce the exact indicia of when such unconstitutional extraterritorial taxation occurs. As a result, states have relied on a variety of incomplete shortcuts—such as a determination of a unitary business—to determine the income to be taxed. These shortcuts, while in some cases sufficient to meet constitutional strictures, fail in other situations (as evidenced here) to protect the taxpayer's constitutional tax limitations. Thus, a decision by this Court in this case is necessary to explain the imperative of considering these constitutional limitations against taxing extraterritorial values and the test for determining when such limits are violated.

Second, this Court has shown a consistent and unique interest in addressing and rectifying unconstitutional dis-

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[2] *See Allied-Signal Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *Hans Rees' Sons v. North Carolina ex re. Maxwell*, 283 U.S. 123 (1931).

crimination against interstate and foreign commerce [3] such as is woefully apparent here. Because of the Eleventh Amendment and the Tax Injunction Act, this Court offers the only federal forum for taxpayers and state taxing jurisdictions alike to have their state tax constitutional issues addressed in a uniform and nonpolitical environment. For these reasons, COST supports Petitioners' request for review and hopes that this Court will accept this case and find in favor of Petitioners.

Explanation of the New Hampshire Business Profits Tax

New Hampshire imposes a tax, the Business Profits Tax,[4] on all corporations doing business in the state. In determining the tax base, New Hampshire adopts the taxpayer's federal taxable income (with some unrelated adjustments). N.H. Rev. Stat. Ann. § 77-A:1, III. For multistate corporations, the amount of this total tax base that New Hampshire taxes is calculated according to the percentage of the taxpayer's property, payroll, and sales (the "apportionment factors") in the state. New Hampshire requires affiliated companies classified as a "unitary business" [5] to file a "combined return." Companies filing a combined return include the total income from each member of the group in a single tax base and determine the percent of the tax base taxable by the state according to the total of the entire group's payroll, property and sales in the state. §§ 77-A:3, I; 77-A:1, XIII. New Hampshire requires only domestic affiliates to be included in the combined return and excludes foreign affiliates.

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[3] In just the past few years, this Court has reviewed three state tax cases involving discrimination against interstate commerce: *Fulton*, *South Central Bell*, and *Hunt-Wesson*.

[4] N.H. Rev. Stat. Ann. Chapter 77-A. (1991 & Supp. 1998).

[5] While no universally applicable definition of unitary business exists, this Court has accepted the description as business "characterized by a flow of value among its companies." *Kraft Gen. Foods v. Iowa Dep't of Rev.*, 505 U.S. 71, 76 (1992).

§ 77-A:1, XV. Thus, to the extent that a New Hampshire taxpayer has a foreign affiliate, that affiliate's tax attributes (the income, expenses and apportionment factors of that affiliate) are excluded from the New Hampshire tax calculation.

In the instant case, the Petitioner companies doing business in New Hampshire have unitary foreign affiliates. Petitioners' domestic unitary group receives income from the foreign affiliates in the form of interest and royalties. Because the income is part of the Petitioners' domestic unitary group's federal taxable income, and because New Hampshire provides no deduction or exclusion for this income, the interest and royalties from foreign affiliates are included in the New Hampshire tax base. Conversely, New Hampshire does not allow the foreign affiliates' apportionment factors to be included in calculating the income taxable by New Hampshire because the foreign affiliates are not part of the return.

Royalties and interest from domestic unitary affiliates receive a different treatment than royalties and interest from foreign unitary affiliates. Like royalties and interest from foreign affiliates, such income from domestic affiliates is included in the New Hampshire tax base. (Technically, the income is included by eliminating both the expense deduction to the affiliate and the income to the parent). However, unlike the foreign income scenario, because the domestic affiliate is included in the combined report, not only is income representing the royalties and interest included in the tax base but the affiliate's apportionment factors are also included in the apportionment formula for the entire unitary group. The result is that to the extent that the affilate generating the royalty and interest income has property, payroll, and sales outside of New Hampshire, some portion of the royalty and interest income will not be taxable by New Hampshire. This can

be contrasted to the foreign royalties and interest where no such accounting for factors outside of New Hampshire occurs because the foreign affiliates generating the income do not have representation in the apportionment factors. It is the inclusion of the royalty and interest income from foreign affiliates in the tax base that is at issue here.

ARGUMENT

I. Under the Commerce Clause of the United States Constitution, New Hampshire's Taxation of Caterpillar's Royalty and Interest Income from Foreign Affiliates Is Unconstitutional Because It Results in the Taxation of Extraterritorial Values.

A. *New Hampshire May Not Constitutionally Tax the Foreign Royalty and Interest Income Because It Is Unrelated To the In-State Activity.*

The Commerce Clause of the United States Constitution prohibits a state from taxing value unrelated to a taxpayer's activities in the state. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). Income can be taxed by the state if it has a variety of relationships with the state. For example, the income may have been directly earned by activities within the state—a sales person selling the taxpayer's product in the state. The income may also be taxed if it is part of the taxpayer's "unitary business." *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 425 U.S. 425 (1980). States are prohibited, however, from taxing income that bears no rational relationship to the in-state value of the corporate enterprise. *Allied-Signal*, 504 U.S. at 772.

In this case, New Hampshire does exactly what is prohibited by the constitution—taxes income earned outside the state with no rational relation to the activities occurring within the state. Petitioners' activities in the state clearly do not give rise to the foreign royalty and interest income; nor does New Hampshire treat the foreign affiliates as part of Petitioners' unitary business.

First, Petitioners' activities in New Hampshire are themselves unrelated to the generation of the foreign royalty and interest income New Hampshire attempts to tax and, thus, cannot be used as the basis for taxing the income. Petitioners and their domestic and foreign affiliates manufacture and sell engines and earth-moving equipment. Brief of Petitioners ("Pet. Br.") at 6. The *only* activity of Petitioners in New Hampshire is the sale of their products to independent dealers. *Id.* Petitioners do not manage their intangible property related to the contested income in New Hampshire, nor do they develop their intangible property in New Hampshire. Petitioners do not sell or advertise to the foreign market from New Hampshire. Similarly, they do not manage their foreign affiliates from New Hampshire; do not manage their loans from New Hampshire; and do not engage in any transactions from New Hampshire that promote or create the foreign income. All of those activities occur elsewhere, primarily abroad or at Petitioners' headquarters in Illinois.

Second, while Petitioners' stipulate that they are part of a unitary business with the foreign affiliates generating the foreign royalty and interest income, New Hampshire does not treat them for state tax purposes as unitary. New Hampshire's own taxing scheme excludes the foreign affiliates from the unitary group. New Hampshire also excludes the income, other than repatriated income, of the foreign affiliates from the tax base and excludes the foreign affiliates' factors entirely from the state apportionment calculation. Historically, this Court has found that a unitary relationship is usually sufficient to prove the requisite relationship to activity within the state. *Mobil Oil*, 425 U.S. 425. Since New Hampshire excludes the foreign affiliates from the combined return, it must also

exclude the income from those affilates from the tax base. The Constitution requires the parallel treatment.

Even if the State succeeds in classifying the income as part of Petitioners' unitary business, the result is still an unconstitutional taxing of extraterritorial values. This Court has noted that merely being a unitary business does not mean that the net profits may be "attributed, regardless of the evidence" to any one state. *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 132 (1931). What is important is that "the method adopted [for taxation must be] reasonably attributable to the processes conducted within the borders of the State." *Id.* at 133. This Court in the same case went on to note that:

> But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State.

A perfect example of when a state, notwithstanding a unitary business relationship, may not tax income because the income was not related to the activities in the state is *British Land (Md.), Inc. v. Tax Appeals Tribunal of N.Y.*, 85 N.Y.2d 139, 647 N.E.2d 1280 (1995). In this case, the taxpayer earned a significant gain from the sale of real estate investments in Maryland that New York sought to tax. The taxpayer purchased the Maryland real estate in 1973 and did not have any business operations in New York until 1982. The court found that the taxpayer's real estate business in New York and in Maryland

was part of a unitary business, but also held that this was not the end of the analysis. The court found that "the gain on the Baltimore property was attributable in far larger part to "factors . . . present in other States but not present in [New York]." *Id.* at 148. The court noted that there was no "significant countervailing flow of value to petitioner's Maryland operation from its activities or the strategic decisions of its officers taking place outside of Maryland." *Id.*

Further, the court determined that any benefits to the Maryland operations from the taxpayer's other unitary affiliates could not be considered because the taxing jurisdiction's own tax regime did not include those affiliates in its tax calculation. This is exactly what happened in the current case. New Hampshire's own taxing scheme rejects the classification of Petitioners' foreign affiliates as unitary by excluding them from the tax base and apportionment factor calculation. Thus, some connection, other than the unitary relationship, must link the foreign generated royalties and income to the New Hampshire activities before that income can be taxed. No such relationship exists, and thus New Hampshire cannot constitutionally tax the income.

This Court has explained that "our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'" *Container*, 463 U.S. at 176. In Petitioners' case, New Hampshire fails to apply the correct standard in that it never considers whether the income is appropriately connected to the activities in the state.[6] If it had considered this standard, the result of upholding the imposition of the

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[6] The New Hampshire Supreme Court held only that the state's tax system did not discriminate against interstate commerce. It failed to consider whether the income in question was from extra-territorial values. Pet. Br. at 13a.

tax is not within the realm of permissible judgment because no rational connection between the foreign activities generating the income and Petitioners' New Hampshire activities exists. Taking *British Land* as the appropriate paradigm, New Hampshire may not constitutionally tax the foreign royalty and interest income and must exclude this income from its tax base.

B. *Even If There Is Some Rational Relationship Between Petitioners' Activities in New Hampshire and the Foreign Royalties and Interest, the Inclusion of That Income In the Tax Base Distorts Petitioners' New Hampshire Tax Out of All Appropriate Proportion To the Business Transacted By Petitioners In the State and, Thus, the Income Must Be Excluded From the Tax Base.*

Income that otherwise bears some minimal link to a taxing state is still constitutionally prohibited from being taxed if the resulting tax is "out of all appropriate proportion to the business transacted by the [taxpayer] in the state." *Hans Rees'*, 283 U.S. at 185.

Here, the inclusion of the foreign royalties and interest so inflates the resulting New Hampshire tax that under the "all appropriate proportion" test of *Hans Rees'*, the income must be excluded from the base (or some other taxing method adopted that will appropriately reflect the extent of Petitioners' activities in the state, such as the inclusion of the foreign factors of production giving rise to the income in question as suggested by Petitioners. Pet. Br. at 14). As Petitioners note, none of the more than thirty-five foreign subsidiaries and affiliates creating the foreign royalties and interest at issue transact any business within New Hampshire. Pet. Br. at 21. New Hampshire does not provide these foreign entities any benefits or protections that help in the generation of the foreign royalty and interest income. *Id.* Petitioners' total

New Hampshire payroll during the three years at issue herin totaled only $193,215 yet New Hampshire wants to claim that this paltry payroll was somehow related to $367,928,469 in royalty and interest income. *Id.* Either the New Hampshire sales force is superhumanly productive or New Hampshire is taxing extraterritorial values. The record supports the latter explanation.

This case is an even more obvious situation of extraterritorial taxation than *Hans Rees'*. In *Hans Rees'* this Court found that the state was unconstitutionally taxing income earned beyond its borders even though the activity in the taxing state was part of the ultimate stream of activities (manufacturing) giving rise to the income in question. Here, the activities in New Hampshire did not result in, promote, bring about, lead, influence, or subsidize the foreign activities creating the income. Thus, even if there is some connection between Petitioners' activities in New Hampshire and the activities creating the foreign royalties and interest, the tax imposed by New Hampshire as a result of those activities is out of all appropriate proportion to the activities occurring in the state. New Hampshire's imposition of the tax is therefore unconstitutional.

II. Under the Commerce Clause, New Hampshire Unconstitutionally Discriminates Against Petitioners' Foreign Affiliates Using a Specific Capitalization Method Because They Are Taxed Differently, and More Severely, than a Domestic Affiliate Using a Similar Capitalization Method.

In order for a tax to be constitutional under the Commerce Clause of the U.S. Constitution, it must "not discriminate against interstate commerce." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In *Kraft General Foods, Inc. v. Iowa Dep't of Rev. and Fin.*, 505 U.S. 71 (1992), this Court recognized that including dividends from foreign subsidiaries in the tax

base while excluding the dividends from domestic subsidiaries unconstitutionally discriminated against foreign commerce. In that case, this Court specificaly rejected the state's argument that the taxpayer could have chosen another corporate structure to avoid the discrimination. *Id.* at 77. The current case involves the exact same problem: Petitioners' choice of capitalization alternatives for foreign affiliates resulted in different and more onerous tax treatment than a similar taxpayer's choice of capitalizing its domestic affiliates.

A business has many choices in how to invest in an affiliate. It may make a capital contribution in return for stock; it may make a loan in exchange for long-term principal repayment; it could operate the investment as an internal division rather than a separately incorporated entity; or it could provide management services, intellectual property, and know-how in exchange for a percentage of the affiliate's profit from operations. If a business makes a capital contribution as the means to finance the affiliate, one method of receiving a return on its investment is through dividends from the affiliate. If the business makes a loan to the affiliate, the return is in the form of interest payments. If a business offers services and property to the affiliate, it receives management fees and royalties in return.

In this case, Petitioners' domestic unitary group provided licenses of intellectual property and loans to the foreign affiliates as their chosen method of financing the foreign business enterprise. Instead of licensing the use of the intangible property, the domestic company could have contributed the foreign rights to the property outright in exchange for stock and any subsequent dividends. The operational result would not have changed—only the capital structure. Similarly, the domestic company could have operated the foreign operations as an internal divi-

sion and thus no transfer of property or income would have occurred. The same options exist for financing domestic operations. The problem in this case is that Petitioners' choice among financing alternatives for their foreign affiliates did not have the same New Hampshire tax results as a similar taxpayer's choice for financing domestic affiliates.

Amicus does not argue that there cannot be distinctions in tax treatment between different capitalization choices, but what is undeniably unconstitutional is a tax distinction between identical capitalization structures for a domestic affiliate versus a foreign affiliate. Unfortunately, this is exactly what New Hampshire imposes here—a taxpayer is subject to a higher tax if it receives royalties and interest from foreign affiliates as compared to receipts from domestic affiliates.

It is the choice in capitalization structure that distinguishes the current situation from the scenario adopted by the New Hampshire Supreme Court of a taxpayer receiving royalties and interest from an unrelated, domestic third party.[7] The New Hampshire Supreme Court found that no discrimination existed because the relevant comparison was between foreign unitary affiliates and domestic unrelated businesses. When a business licenses its property, or loans funds to an independent third-party it is because it is in the business of licensing and lending. However, when the same transaction occurs with an affiliate

---

[7] The Hampshire Supreme Court decided that:

> The foreign members of Caterpillar's unitary group are considered unrelated businesses . . . . Hence the proper comparison is between the foreign members of the unitary group and unrelated domestic entities.

Pet. Br. at 10a. By this statement, the court magically whisked away Petitioners' entire corporate structure. Petitioners did not treat these foreign affiliates as unrelated business entities and the court's chosen comparison is inaccurate.

it is to promote the overall capital structure of the business enterprise as a whole. Thus, the relevant comparison in tax treatment is between affiliated corporations.

New Hampshire, in its treatment of dividends, has recognized the principle articulated in *Kraft* that a state may not tax income from foreign sources more onerously than income from domestic sources. Under the New Hampshire tax statute, the foreign dividend payor's factors generating the foreign dividends are included in the state apportionment formula. N.H. Rev. Stat. Ann. § 77-A:3, II. Similar treatment is necessary in the current case to avoid a *Kraft*-like discrimination against foreign royalties and interest.

CONCLUSION

For the reasons stated above, and because this tax scheme is one confronted and challenged by taxpayers in several states, COST respectfully requests the Court to accept this case for review.

Respectfully submitted,

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No. 99 - 1214

In the
Supreme Court of the United States

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Petitioners,
v.
THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION AND STANLEY R. ARNOLD, JR., THE NEW HAMPSHIRE COMMISSIONER OF REVENUE,
Respondents.

On Petition for A Writ of *Certiorari* to the Supreme Court of New Hampshire

---

BRIEF OF *AMICI CURIÆ* BUSINESS AND INDUSTRY ASSOCIATION OF NEW HAMPSHIRE AND NEW ENGLAND LEGAL FOUNDATION IN SUPPORT OF PETITIONER

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---

MOTION OF AMICI CURIAE BUSINESS AND INDUSTRY ASSOCIATION OF NEW HAMPSHIRE AND NEW ENGLAND LEGAL FOUNDATION FOR LEAVE TO FILE BRIEF IN SUPPORT OF PETITIONER

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Pursuant to Supreme Court Rule 37.2, counsel for *Amici Curiae*, who are employed by the New England Legal Foundation, have attempted to secure written consent for the filing of the attached Brief *Amici Curiae* from counsel for the Petitioners and Respondents. Although counsel for Petitioners granted such consent, counsel for Respondents withheld it. Accordingly, counsel for *Amici Curiae* hereby move this Court for leave to file the Brief *Amici Curiae* which is submitted herewith. *Amici* makes this motion on the following grounds:

Amicus Curiae the Business & Industry Association of New Hampshire ("BIA") is a statewide, membership driven organization, where leaders from varied business organizations come together in an effort to understand and affect public policy. The BIA solicits information, conducts research and analysis, provides a responsible forum to address problems facing New Hampshire's business community, and seeks to develop and present constructive solutions. The BIA's efforts are implemented through five professionally staffed member-oriented standing policy committees: Fiscal Policy, Human Resources, Environment, Economic Development and Energy Affairs & Regulated Industries. Findings and policy initiatives are then moved to the Board of Directors. The BIA serves the New Hampshire business community as the only statewide, nonpartisan voice representing the interests of all New Hampshire businesses, large and small, across all industries, on key issues and in every public policy forum.

Amicus curiae New England Legal Foundation ("NELF") is a non-profit, public interest law firm, incorporated in Massachusetts in 1977. Its membership consists of corporations, law firms, individuals, and others who believe in NELF's mission of promoting balanced economic growth for New England, protecting the free enterprise system, and defending economic rights. NELF's more than 130 members and supporters include a cross-section of large and small

corporations from all parts of the New England and the United States, including several multinational corporations. NELF has regularly appeared in state and federal court, as party or counsel, in cases raising issues of general economic significance to the business community. *See, e.g., Natsios v. National Foreign Trade Council*, 181 F.3d 38 (1st Cir.), *cert. granted*, 120 S. Ct. 525 (1999); *UNUM Life Ins. Co. v. Ward*, 526 U.S. 358 (1999); *BMW v. Gore*, 517 U.S. 559 (1996); *Reich v. Southern New England Telecommunications Corp.*, 121 F.3d 58 (2d Cir. 1997); *Georgine v. Amchem Products, Inc.*, 83 F.3d 610 (3d Cir. 1996); *Conservation Law Foundation v. Department of the Air Force*, 79 F.3d 1250 (1st Cir. 1996); *Preseault v. United States*, 66 F.3d 1167 (Fed. Cir. 1995).

Amici seek to bring to the Court's attention their views, and those of their supporters, concerning the proper taxation of income and interest from foreign subsidiaries of domestic corporations. If the decision below is not reversed, state taxing authorities will be encouraged to continue to overstate the income apportionable to their states and continue to tax foreign income at a rate higher than domestic income, discouraging foreign investment which is essential in our global economy.

Wherefore, BIA and NELF respectfully request that this Court grant *Amici Curiae* leave to file the attached brief in support of the Petition for a Writ of *Certiorari*.

Respectfully submitted,

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The New England Legal Foundation ("NELF"), a non-

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1. Pursuant to Supreme Court Rule 37.6, counsel for *amici* state that counsel for neither Petitioner nor Respondent authored this brief in whole or in part and no person or entity other than *amici* made a monetary contribution to the preparation or submission of the brief.

profit, public interest law firm, was incorporated in 1977. Its membership consists of individuals, businesses, and others who believe in promoting balanced economic growth for New England, protecting the free enterprise system, and defending economic rights. NELF's more than 130 members and supporters include a cross-section of large and small businesses from all parts of New England and the United States. NELF has regularly appeared in state and federal court, as party or counsel, in cases raising issues of general economic significance to the business community. *E.g., Natsios v. National Foreign Trade Council*, 181 F.3d 38 (1st Cir.), *cert. granted*, 120 S. Ct. 525 (1999); *UNUM Life Ins. Co. v. Ward*, 526 U.S. 358 (1999); *BMW v. Gore*, 517 U.S. 559 (1996); *Reich v. Southern New England Telecommunications Corp.*, 121 F.3d 58 (2d Cir. 1997); *Georgine v. Amchem Products, Inc.*, 83 F.3d 610 (3d Cir. 1996); *Conservation Law Foundation v. Department of the Air Force*, 79 F.3d 1250 (1st Cir. 1996); *Preseault v. United States*, 66 F.3d 1167 (Fed. Cir. 1995).

Amici seek to bring to the Court's attention their views, and those of their supporters, concerning the proper taxation of income and interest from foreign subsidiaries of domestic corporations. If the decision below is not reversed, state taxing authorities will be encouraged to continue to overstate the income apportionable to their states and continue to tax foreign income at a rate higher than domestic income, thus undermining the ability of United States companies to compete and discouraging foreign investment, both of which are essential in today's global economy.

SUMMARY OF ARGUMENT

This Court should grant Caterpillar's Petition and answer the questions left unresolved by this Court's prior decisions dealing with state taxation of intangible income from

foreign subsidiaries.

Under New Hampshire's "water's" edge approach, intangible income received by a United States parent company from foreign subsidiaries, such as the interest and royalty payments Caterpillar received, is included in the parent's tax base without "factor representation." No portion of the payroll, property or sales factors of the foreign subsidiaries is included in New Hampshire's apportionment formula. The New Hampshire scheme, thus, disregards the unitary business principle which provides the basis for New Hampshire's taxation of Caterpillar's activities outside its borders.

Contrary to the holding of the New Hampshire Supreme Court, Caterpillar's subsidiaries are not unrelated business entities and should not be treated as such. They should be treated consistently with Caterpillar's domestic subsidiaries and the appropriate portion of the foreign subsidiaries' payroll, property and sales factors should be included in the apportionment formula. Without any consideration of these factors, New Hampshire discriminates against foreign commerce, taxing it at a higher rate than domestic commerce, and discourages foreign investment.

ARGUMENT

THIS COURT SHOULD GRANT THE PETITION TO RESOLVE AN IMPORTANT QUESTION CONCERNING THE CONSTITUTIONALITY OF STATE TAXATION OF INTANGIBLE INCOME RECEIVED FROM FOREIGN SUBSIDIARIES OF UNITED STATES CORPORATIONS.

A. Under New Hampshire's "Water's Edge" Approach, Income from Caterpillar's Foreign Subsidiaries Is Included in Caterpillar's Taxable Income But No Portion of the Factors Which Generated that Income Is Included in the Apportionment Formula.

The facts are stipulated. Caterpillar is a Delaware corporation having its principal place of business in Illinois. During the tax years in dispute, Caterpillar owned over 50 foreign and domestic subsidiaries. Caterpillar stipulated that it and all of its subsidiaries were engaged in a single "unitary business" as defined in N.H. RSA 77-A:1, XIV. Only three of the corporations, the petitioners, conducted any business in New Hampshire. According to Caterpillar, this business activity "was limited to the ownership of personal property located in New Hampshire and the solicitation of sales to unrelated, independent dealers in New Hampshire." Petition at 6.

New Hampshire apportions the income of a "unitary business" between New Hampshire and all other states using a formula based on three factors: (1) the "property" factor, which compares tangible property owned in New Hampshire to tangible property owned everywhere; (2) the "payroll" factor, which compares payroll in New Hampshire to payroll everywhere; and (3) the "sales" factor, which compares New

Hampshire sales to sales everywhere. These fractions are averaged and the resulting fraction applied against the total taxable income of Caterpillar's unitary business to determine the amount that is apportioned to, and taxable by, New Hampshire.

Before 1987, New Hampshire applied this unitary business principle on a worldwide basis. In 1987, New Hampshire amended its tax code and limited the business profits tax to the "water's edge" by eliminating foreign business organizations from this tax. Under the New Hampshire scheme, like those of many other states, income earned by foreign subsidiaries is excluded from the calculation of a unitary business' combined net income that is subject to apportionment. However, in the year in which income from foreign subsidiaries is returned to Caterpillar in the U.S. in the form of interest and royalty payments, it is included in the Caterpillar's unitary business income. Under New Hampshire's "water's edge" approach, none of the factors that generated that income are considered.

New Hampshire's inclusion of the interest and royalty income from foreign subsidiaries without "factor representation" — inclusion of some portion of the costs incurred by the foreign subsidiaries — violates the Commerce Clause because it discriminates against foreign commerce, taxing it more severely than income of domestic subsidiaries, and violates the Due Process Clause because it vastly overstates New Hampshire income by abandoning the unitary business principle.

B. Intangible Income from Foreign Subsidiaries Is Apportionable Because the Foreign Subsidiaries Are Part of Caterpillar's Unitary Business, Not Unrelated Businesses.

"[I]t is fundamental that a State has no power to impose a tax on income earned outside of the State." *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 422, 451 (1980) (Stevens, J., dissenting). *Accord Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317, 325 (1968). This principle rests on the constitutional requirement that there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954); *Mobil Oil* , 445 U.S. at 436-37. This doctrine "derives from the virtually axiomatic proposition that the exercise of a state's power over a taxpayer's activities is justified by the 'protection, opportunities and benefits' the state confers upon those activities." W. Hellerstein, *State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond*, 48 Tax L. Rev. 739, 745 (1993) (quoting *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940)).

A "unitary business" that has in-state and out-of-state activities provides the necessary "minimal connection." *Mobil Oil*, 445 U.S. at 439. Caterpillar stipulated that it was engaged in a unitary business with all its foreign and domestic subsidiaries. Accordingly, New Hampshire "must . . . apply a formula apportioning the income of [a unitary business] within and without the State." *Container Corp. v. Franchise Tax Board*, 463 U. S. 159, 169 (1983). That formula must, "under the Due Process and Commerce Clauses, be fair." *Id.*

This Court has established a two-part text of fairness:

> The first . . . component of fairness in an apportionment formula is what might be called internal consistency — that is, the formula must be such that, if applied in every jurisdiction, it would result in no more than all of the unitary business' income being taxed. The second and more difficult requirement is what might be called external consistency — *the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.*

Id. (emphasis added). This Court has approved the "three factor" formula used by New Hampshire and many other states. This Court has also held that states may constitutionally include intangible income from foreign subsidiaries in the apportionable income of a unitary business. *Mobil Oil*, 445 U.S. at 441.

This Court has not resolved whether inclusion of that income without any factor representation is constitutionally permissible. *Container Corp.*, 463 U.S. at 168 n. 5. Justice Stevens, in his dissent in *Mobil Oil*, squarely addressed the issue and expressed his opinion that it is not.

> Unless the sales, payroll and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause Mobil's Vermont income to be overstated.

Mobil Oil, 445 U.S. at 461 (Stevens, J., dissenting). He reasoned that

> Either Mobil's worldwide 'petroleum enterprise' . . . is all part of one unitary business, or it is not; if it is, Vermont must evaluate the entire enterprise in a consistent manner.

Id. To evaluate a worldwide unitary enterprise consistently, Justice Stevens concluded that the payroll, property and sales of the foreign subsidiaries must be taken into account. *Id.* at 462.

The New Hampshire Supreme Court concluded, however, that the Department treated Caterpillar's unitary group — consisting of only the domestic subsidiaries — consistently and held, without analysis, that the Department properly considered the foreign subsidiaries as unrelated businesses that paid interest and royalties to Caterpillar.

Foreign subsidiaries, however, are not unrelated businesses in which Caterpillar has invested or to which it has licensed technology. They, like the domestic subsidiaries, are part of a unitary business.[2] Being part of that unitary business is what subjects their payments of interest and royalties to taxation in New Hampshire. As prominent tax commentators have explained:

> When . . . the formula gives no recognition to the payroll, property, and sales of the entities that helped generate the apportionable income, and whose unitary relationship to the payor provides the predicate for apportionability, there

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2. Interest and royalty income from unrelated businesses would be taxable by New Hampshire only if "the capital transaction" serves an operational, not investment, function. *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U. S. 768, 787 (1992).

> ceases to be a rational relationship between the income being taxed and the activities that give rise to the income. In short, a state should not be able to have it both ways: including income of subsidiaries in the parent's apportionable tax base on the theory that the parent and the subsidiary are engaged in a unitary business but then apportioning such income by factors reflecting only the parent's own operations on a separate company basis.

Jerome R. Hellerstein & Walter Hellerstein, State Taxation ¶9.15[2] at 9-118 (3d ed. 1998). This reasoning applies equally to foreign and domestic subsidiaries. *Id.* at ¶ 9.15[4][c] at 9-141.

Without some factor representation, the income apportioned to New Hampshire from the interest and royalty payments of Caterpillar's foreign subsidiaries (with which New Hampshire has no connection and upon which it confers no benefits), is out of all proportion to Caterpillar's activities in New Hampshire. It is not apportioned, as constitutionally required, in a manner which "actually reflect[s] a reasonable sense of how income is generated." *Container Corp.*, 463 U.S. at 169.

New Hampshire's inclusion of intangible income from foreign subsidiaries without any factor representation also "treats foreign source income less favorably than it treats domestic source income." Hellerstein & Hellerstein, *supra*, ¶9.15[4] [c] at 9-141. As Justice Powell noted in his dissent in *Container Corp.*, "such a tax has the effect of discouraging investment in [foreign] countries." 463 U.S. at 202. Investment in foreign countries, critical in today's competitive,

global economy, should be encouraged by fair taxation of income from foreign subsidiaries, not discouraged by New Hampshire's unfair "water's edge" scheme.

CONCLUSION

For the foregoing reasons, and those set forth in Caterpillar's Petition, this Court should grant the Petition, and take this opportunity to answer the questions left open in *Mobil Oil* and *Container Corp.*, which will provide much-needed guidance to state taxing authorities and taxpayers as well.

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No. 99-1214

CATERPILLAR INC.,
CATERPILLAR FINANCIAL SERVICES CORPORATION,
and SOLAR TURBINES INCORPORATED,
Petitioners,

v.

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION and STANLEY R. ARNOLD, JR.,
THE NEW HAMPSHIRE COMMISSIONER OF REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of New Hampshire

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

The Committee On State Taxation (COST) respectfully requests leave to file a Brief as *Amicus Curiae* in support of Petitioners. The interest of COST as *amicus curiae* is described *infra* at Brief, pp. 1-3. Counsel for Petitioners has consented to COST's filing of an *amicus* brief. Despite COST's qualifications to submit an *amicus* brief, Counsel for Respondents has refused to consent to the filing of such a brief. However, in the absence of such

permission there is a compelling reason for granting this request.

This Court should grant COST leave to file its *amicus* brief because COST has additional observations, not fully addressed by Petitioners, to make concerning the constitutional implications of the New Hampshire Business Profits Tax. Specifically, COST discusses why the income at issue being taxed by New Hampshire should not constitutionally be included in the tax base. While Petitioners raised this issue, it is further developed in COST's brief. COST also discusses the discrimination against affiliate capitalization structures resulting from the New Hampshire tax system. This discussion offers an alternative view and analysis of the discrimination against foreign commerce detailed by the Petitioners. Thus, COST's brief gives this Court both additional information and an additional method for analyzing the issues.

Respectfully submitted,

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BRIEF OF *AMICUS CURIAE* COMMITTEE ON STATE TAXATION IN SUPPORT OF PETITIONERS

INTEREST OF *AMICUS CURIAE*

This brief is submitted by the Committee On State Taxation (COST) as *amicus curiae* in support of Petitioners in the above captioned matter.[1] COST's ob-

[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioners has been obtained and filed with the Clerk of the Court.

jective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce and was separately incorporated on January 1, 1992. COST's membership consists of over 500 multistate corporations involved in interstate and international commerce.

COST is submitting this brief because systematic and distortive overcharging by state tax systems, such as the one at issue here, unconstitutionally discriminates against interstate commerce and impedes business's ability to operate in the global economy. New Hampshire has reached beyond its borders to unconstitutionally extract taxes from international business enterprises. *Amicus* hopes that this Court will not allow unconstitutional overcharging to quietly slide into established law and thereby be accepted by taxing authorities in New Hampshire and elsewhere. Such a diminution in taxpayers' constitutional protections threatens the foundations of the state tax system by risking excessive burdens on commerce. COST and its members are concerned that such burdens could become institutionalized elements of state tax systems. Further, New Hampshire's discriminatory method of taxing royalties and interest from foreign affiliates is shared by other states. Thus, not only are COST members with such foreign income unconstitutionally discriminated against in New Hampshire, but they are subject to similar unconstitutional systems in many other states. Thus, COST and its members have a particular interest in seeing the New Hampshire system reviewed (and invalidated) both because of the direct impact on the taxing scheme in New Hampshire and the resulting impact on other, similar state tax schemes. COST and its members request this Court to reiterate and expound upon the constitutional principles

prohibiting the tax on extraterritorial values and the discrimination suffered by Petitioners and many similar taxpayers in New Hampshire and elsewhere.

REASONS FOR GRANTING THE PETITION

COST asks this Court to accept this case to determine that New Hampshire violated the Commerce Clause of the United States Constitution by taxing income with no relation to the state and by taxing income from foreign affiliates differently, and more onerously, than income from domestic affiliates.

First, this case offers this Court the forum to complete its analysis as to what constitutes an unconstitutional tax on extraterritorial values [2] and, more importantly, to offer the state taxing jurisdictions a template to prevent future violations. While this Court has frequently stated that a state may not tax extraterritorial values, it has not previously had the opportunity to announce the exact indicia of when such unconstitutional extraterritorial taxation occurs. As a result, states have relied on a variety of incomplete shortcuts—such as a determination of a unitary business—to determine the income to be taxed. These shortcuts, while in some cases sufficient to meet constitutional strictures, fail in other situations (as evidenced here) to protect the taxpayer's constitutional tax limitations. Thus, a decision by this Court in this case is necessary to explain the imperative of considering these constitutional limitations against taxing extraterritorial values and the test for determining when such limits are violated.

Second, this Court has shown a consistent and unique interest in addressing and rectifying unconstitutional dis-

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[2] *See Allied-Signal Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *Hans Rees' Sons v. North Carolina ex re. Maxwell*, 283 U.S. 123 (1931).

crimination against interstate and foreign commerce [3] such as is woefully apparent here. Because of the Eleventh Amendment and the Tax Injunction Act, this Court offers the only federal forum for taxpayers and state taxing jurisdictions alike to have their state tax constitutional issues addressed in a uniform and nonpolitical environment. For these reasons, COST supports Petitioners' request for review and hopes that this Court will accept this case and find in favor of Petitioners.

Explanation of the New Hampshire Business Profits Tax

New Hampshire imposes a tax, the Business Profits Tax,[4] on all corporations doing business in the state. In determining the tax base, New Hampshire adopts the taxpayer's federal taxable income (with some unrelated adjustments). N.H. Rev. Stat. Ann. § 77-A:1, III. For multistate corporations, the amount of this total tax base that New Hampshire taxes is calculated according to the percentage of the taxpayer's property, payroll, and sales (the "apportionment factors") in the state. New Hampshire requires affiliated companies classified as a "unitary business" [5] to file a "combined return." Companies filing a combined return include the total income from each member of the group in a single tax base and determine the percent of the tax base taxable by the state according to the total of the entire group's payroll, property and sales in the state. §§ 77-A:3, I; 77-A:1, XIII. New Hampshire requires only domestic affiliates to be included in the combined return and excludes foreign affiliates.

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[3] In just the past few years, this Court has reviewed three state tax cases involving discrimination against interstate commerce: *Fulton*, *South Central Bell*, and *Hunt-Wesson*.

[4] N.H. Rev. Stat. Ann. Chapter 77-A. (1991 & Supp. 1998).

[5] While no universally applicable definition of unitary business exists, this Court has accepted the description as business "characterized by a flow of value among its companies." *Kraft Gen. Foods v. Iowa Dep't of Rev.*, 505 U.S. 71, 76 (1992).

§ 77-A:1, XV. Thus, to the extent that a New Hampshire taxpayer has a foreign affiliate, that affiliate's tax attributes (the income, expenses and apportionment factors of that affiliate) are excluded from the New Hampshire tax calculation.

In the instant case, the Petitioner companies doing business in New Hampshire have unitary foreign affiliates. Petitioners' domestic unitary group receives income from the foreign affiliates in the form of interest and royalties. Because the income is part of the Petitioners' domestic unitary group's federal taxable income, and because New Hampshire provides no deduction or exclusion for this income, the interest and royalties from foreign affiliates are included in the New Hampshire tax base. Conversely, New Hampshire does not allow the foreign affiliates' apportionment factors to be included in calculating the income taxable by New Hampshire because the foreign affiliates are not part of the return.

Royalties and interest from domestic unitary affiliates receive a different treatment than royalties and interest from foreign unitary affiliates. Like royalties and interest from foreign affiliates, such income from domestic affiliates is included in the New Hampshire tax base. (Technically, the income is included by eliminating both the expense deduction to the affiliate and the income to the parent). However, unlike the foreign income scenario, because the domestic affiliate is included in the combined report, not only is income representing the royalties and interest included in the tax base but the affiliate's apportionment factors are also included in the apportionment formula for the entire unitary group. The result is that to the extent that the affiliate generating the royalty and interest income has property, payroll, and sales outside of New Hampshire, some portion of the royalty and interest income will not be taxable by New Hampshire. This can

be contrasted to the foreign royalties and interest where no such accounting for factors outside of New Hampshire occurs because the foreign affiliates generating the income do not have representation in the apportionment factors. It is the inclusion of the royalty and interest income from foreign affiliates in the tax base that is at issue here.

ARGUMENT

I. Under the Commerce Clause of the United States Constitution, New Hampshire's Taxation of Caterpillar's Royalty and Interest Income from Foreign Affiliates Is Unconstitutional Because It Results in the Taxation of Extraterritorial Values.

A. *New Hampshire May Not Constitutionally Tax the Foreign Royalty and Interest Income Because It Is Unrelated To the In-State Activity.*

The Commerce Clause of the United States Constitution prohibits a state from taxing value unrelated to a taxpayer's activities in the state. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). Income can be taxed by the state if it has a variety of relationships with the state. For example, the income may have been directly earned by activities within the state—a sales person selling the taxpayer's product in the state. The income may also be taxed if it is part of the taxpayer's "unitary business." *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 425 U.S. 425 (1980). States are prohibited, however, from taxing income that bears no rational relationship to the in-state value of the corporate enterprise. *Allied-Signal*, 504 U.S. at 772.

In this case, New Hampshire does exactly what is prohibited by the constitution—taxes income earned outside the state with no rational relation to the activities occurring within the state. Petitioners' activities in the state clearly do not give rise to the foreign royalty and interest income; nor does New Hampshire treat the foreign affiliates as part of Petitioners' unitary business.

First, Petitioners' activities in New Hampshire are themselves unrelated to the generation of the foreign royalty and interest income New Hampshire attempts to tax and, thus, cannot be used as the basis for taxing the income. Petitioners and their domestic and foreign affiliates manufacture and sell engines and earth-moving equipment. Brief of Petitioners ("Pet. Br.") at 6. The *only* activity of Petitioners in New Hampshire is the sale of their products to independent dealers. *Id.* Petitioners do not manage their intangible property related to the contested income in New Hampshire, nor do they develop their intangible property in New Hampshire. Petitioners do not sell or advertise to the foreign market from New Hampshire. Similarly, they do not manage their foreign affiliates from New Hampshire; do not manage their loans from New Hampshire; and do not engage in any transactions from New Hampshire that promote or create the foreign income. All of those activities occur elsewhere, primarily abroad or at Petitioners' headquarters in Illinois.

Second, while Petitioners' stipulate that they are part of a unitary business with the foreign affiliates generating the foreign royalty and interest income, New Hampshire does not treat them for state tax purposes as unitary. New Hampshire's own taxing scheme excludes the foreign affiliates from the unitary group. New Hampshire also excludes the income, other than repatriated income, of the foreign affiliates from the tax base and excludes the foreign affiliates' factors entirely from the state apportionment calculation. Historically, this Court has found that a unitary relationship is usually sufficient to prove the requisite relationship to activity within the state. *Mobil Oil*, 425 U.S. 425. Since New Hampshire excludes the foreign affiliates from the combined return, it must also

exclude the income from those affiliates from the tax base. The Constitution requires the parallel treatment.

Even if the State succeeds in classifying the income as part of Petitioners' unitary business, the result is still an unconstitutional taxing of extraterritorial values. This Court has noted that merely being a unitary business does not mean that the net profits may be "attributed, regardless of the evidence" to any one state. *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 132 (1931). What is important is that "the method adopted [for taxation must be] reasonably attributable to the processes conducted within the borders of the State." *Id.* at 133. This Court in the same case went on to note that:

> But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State.

A perfect example of when a state, notwithstanding a unitary business relationship, may not tax income because the income was not related to the activities in the state is *British Land (Md.), Inc. v. Tax Appeals Tribunal of N.Y.*, 85 N.Y.2d 139, 647 N.E.2d 1280 (1995). In this case, the taxpayer earned a significant gain from the sale of real estate investments in Maryland that New York sought to tax. The taxpayer purchased the Maryland real estate in 1973 and did not have any business operations in New York until 1982. The court found that the taxpayer's real estate business in New York and in Maryland

was part of a unitary business, but also held that this was not the end of the analysis. The court found that "the gain on the Baltimore property was attributable in far larger part to "factors . . . present in other States but not present in [New York]." *Id.* at 148. The court noted that there was no "significant countervailing flow of value to petitioner's Maryland operation from its activities or the strategic decisions of its officers taking place outside of Maryland." *Id.*

Further, the court determined that any benefits to the Maryland operations from the taxpayer's other unitary affiliates could not be considered because the taxing jurisdiction's own tax regime did not include those affiliates in its tax calculation. This is exactly what happened in the current case. New Hampshire's own taxing scheme rejects the classification of Petitioners' foreign affiliates as unitary by excluding them from the tax base and apportionment factor calculation. Thus, some connection, other than the unitary relationship, must link the foreign generated royalties and income to the New Hampshire activities before that income can be taxed. No such relationship exists, and thus New Hampshire cannot constitutionally tax the income.

This Court has explained that "our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'" *Container*, 463 U.S. at 176. In Petitioners' case, New Hampshire fails to apply the correct standard in that it never considers whether the income is appropriately connected to the activities in the state.[6] If it had considered this standard, the result of upholding the imposition of the

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[6] The New Hampshire Supreme Court held only that the state's tax system did not discriminate against interstate commerce. It failed to consider whether the income in question was from extra-territorial values. Pet. Br. at 13a.

tax is not within the realm of permissible judgment because no rational connection between the foreign activities generating the income and Petitioners' New Hampshire activities exists. Taking *British Land* as the appropriate paradigm, New Hampshire may not constitutionally tax the foreign royalty and interest income and must exclude this income from its tax base.

B. *Even If There Is Some Rational Relationship Between Petitioners' Activities in New Hampshire and the Foreign Royalties and Interest, the Inclusion of That Income In the Tax Base Distorts Petitioners' New Hampshire Tax Out of All Appropriate Proportion To the Business Transacted By Petitioners In the State and, Thus, the Income Must Be Excluded From the Tax Base.*

Income that otherwise bears some minimal link to a taxing state is still constitutionally prohibited from being taxed if the resulting tax is "out of all appropriate proportion to the business transacted by the [taxpayer] in the state." *Hans Rees'*, 283 U.S. at 185.

Here, the inclusion of the foreign royalties and interest so inflates the resulting New Hampshire tax that under the "all appropriate proportion" test of *Hans Rees'*, the income must be excluded from the base (or some other taxing method adopted that will appropriately reflect the extent of Petitioners' activities in the state, such as the inclusion of the foreign factors of production giving rise to the income in question as suggested by Petitioners. Pet. Br. at 14). As Petitioners note, none of the more than thirty-five foreign subsidiaries and affiliates creating the foreign royalties and interest at issue transact any business within New Hampshire. Pet. Br. at 21. New Hampshire does not provide these foreign entities any benefits or protections that help in the generation of the foreign royalty and interest income. *Id.* Petitioners' total

New Hampshire payroll during the three years at issue herein totaled only $193,215 yet New Hampshire wants to claim that this paltry payroll was somehow related to $367,928,469 in royalty and interest income. *Id.* Either the New Hampshire sales force is superhumanly productive or New Hampshire is taxing extraterritorial values. The record supports the latter explanation.

This case is an even more obvious situation of extraterritorial taxation than *Hans Rees'*. In *Hans Rees'* this Court found that the state was unconstitutionally taxing income earned beyond its borders even though the activity in the taxing state was part of the ultimate stream of activities (manufacturing) giving rise to the income in question. Here, the activities in New Hampshire did not result in, promote, bring about, lead, influence, or subsidize the foreign activities creating the income. Thus, even if there is some connection between Petitioners' activities in New Hampshire and the activities creating the foreign royalties and interest, the tax imposed by New Hampshire as a result of those activities is out of all appropriate proportion to the activities occurring in the state. New Hampshire's imposition of the tax is therefore unconstitutional.

II. Under the Commerce Clause, New Hampshire Unconstitutionally Discriminates Against Petitioners' Foreign Affiliates Using a Specific Capitalization Method Because They Are Taxed Differently, and More Severely, than a Domestic Affiliate Using a Similar Capitalization Method.

In order for a tax to be constitutional under the Commerce Clause of the U.S. Constitution, it must "not discriminate against interstate commerce." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In *Kraft General Foods, Inc. v. Iowa Dep't of Rev. and Fin.*, 505 U.S. 71 (1992), this Court recognized that including dividends from foreign subsidiaries in the tax

base while excluding the dividends from domestic subsidiaries unconstitutionally discriminated against foreign commerce. In that case, this Court specifically rejected the state's argument that the taxpayer could have chosen another corporate structure to avoid the discrimination. *Id.* at 77. The current case involves the exact same problem: Petitioners' choice of capitalization alternatives for foreign affiliates resulted in different and more onerous tax treatment than a similar taxpayer's choice of capitalizing its domestic affiliates.

A business has many choices in how to invest in an affiliate. It may make a capital contribution in return for stock; it may make a loan in exchange for long-term principal repayment; it could operate the investment as an internal division rather than a separately incorporated entity; or it could provide management services, intellectual property, and know-how in exchange for a percentage of the affiliate's profit from operations. If a business makes a capital contribution as the means to finance the affiliate, one method of receiving a return on its investment is through dividends from the affiliate. If the business makes a loan to the affiliate, the return is in the form of interest payments. If a business offers services and property to the affiliate, it receives management fees and royalties in return.

In this case, Petitioners' domestic unitary group provided licenses of intellectual property and loans to the foreign affiliates as their chosen method of financing the foreign business enterprise. Instead of licensing the use of the intangible property, the domestic company could have contributed the foreign rights to the property outright in exchange for stock and any subsequent dividends. The operational result would not have changed—only the capital structure. Similarly, the domestic company could have operated the foreign operations as an internal divi-

sion and thus no transfer of property or income would have occurred. The same options exist for financing domestic operations. The problem in this case is that Petitioners' choice among financing alternatives for their foreign affiliates did not have the same New Hampshire tax results as a similar taxpayer's choice for financing domestic affiliates.

Amicus does not argue that there cannot be distinctions in tax treatment between different capitalization choices, but what is undeniably unconstitutional is a tax distinction between identical capitalization structures for a domestic affiliate versus a foreign affiliate. Unfortunately, this is exactly what New Hampshire imposes here—a taxpayer is subject to a higher tax if it receives royalties and interest from foreign affiliates as compared to receipts from domestic affiliates.

It is the choice in capitalization structure that distinguishes the current situation from the scenario adopted by the New Hampshire Supreme Court of a taxpayer receiving royalties and interest from an unrelated, domestic third party.[7] The New Hampshire Supreme Court found that no discrimination existed because the relevant comparison was between foreign unitary affiliates and domestic unrelated businesses. When a business licenses its property, or loans funds to an independent third-party it is because it is in the business of licensing and lending. However, when the same transaction occurs with an affiliate

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[7] The New Hampshire Supreme Court decided that:

> The foreign members of Caterpillar's unitary group are considered unrelated businesses . . . . Hence the proper comparison is between the foreign members of the unitary group and unrelated domestic entities.

Pet. Br. at 10a. By this statement, the court magically whisked away Petitioners' entire corporate structure. Petitioners did not treat these foreign affiliates as unrelated business entities and the court's chosen comparison is inaccurate.

it is to promote the overall capital structure of the business enterprise as a whole. Thus, the relevant comparison in tax treatment is between affiliated corporations.

New Hampshire, in its treatment of dividends, has recognized the principle articulated in *Kraft* that a state may not tax income from foreign sources more onerously than income from domestic sources. Under the New Hampshire tax statute, the foreign dividend payor's factors generating the foreign dividends are included in the state apportionment formula. N.H. Rev. Stat. Ann. § 77-A:3, II. Similar treatment is necessary in the current case to avoid a *Kraft*-like discrimination against foreign royalties and interest.

CONCLUSION

For the reasons stated above, and because this tax scheme is one confronted and challenged by taxpayers in several states, COST respectfully requests the Court to accept this case for review.

Respectfully submitted,

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I.

RESPONDENTS FAIL TO REBUT THE DISCRIMINATION AGAINST CATERPILLAR

A. Respondents' Own Examples Confirm That Their Treatment Of Foreign Unitary Royalties and Interest Inevitably Results In Discrimination.

The examples contained in Respondents' Brief confirm that discrimination will result in every instance where a domestic parent corporation moves the operations of a domestic unitary subsidiary to a foreign location. Respondents' examples illustrate the inevitable discrimination that occurs when the royalties and interest are paid by a domestic unitary subsidiary as compared to a foreign unitary subsidiary. In every instance the tax due is greater when the royalties and interest are paid by a foreign subsidiary.[1]

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[1] The amount of tax due for each of Respondents' examples was determined by first multiplying the royalties and/or interest by the apportionment percentages determined by Respondents in each example to arrive at a tax base. The tax base was then multiplied by the tax rate of 8%. For example, for the example at 12a-13a in Appendix C, the $500 was multiplied by the 3.0706% apportionment percentage determined by Respondents to arrive at a tax base of $15.35. This tax base was then multiplied by the tax rate (*i.e.*, 8%) to arrive at a tax due of $1.23. Similarly, for the example at 14a-15a in Appendix C, the $500 was multiplied by the 3.1908% apportionment percentage determined by Respondents to arrive at a tax base of $15.95. This tax base was then multiplied by the tax rate (*i.e.*, 8%) to arrive at a tax due of $1.28.

Appendix C Examples	Royalties & Interest	**Tax Due with Domestic Subsidiary**	**Tax Due with Foreign Subsidiary**
12a-15a	$500	**$1.23**	**$1.28**
16a-17a	$20,000	**$29.33**	**$35.69**
18a-19a	$50,000	**$35.00**	**$36.56**
20a-21a	$500	**$1.05**	**$1.15**

In Appendix C, at 12a-15a (the first two examples involving the payment of unitary royalties and/or interest), the unitary subsidiary pays $500 of interest to its parent corporation. In the first example (at 12a-13a), where the subsidiary is a domestic corporation, the tax due on the $500 is $1.23. In the second example (at 14a-15a), where the subsidiary is now a foreign corporation, the tax due on the $500 is *increased* to $1.28. This increased tax is due to the fact that while the $500 is included in the tax base in each example, the apportionment percentage in the first example (*i.e.*, for the domestic subsidiary) includes the subsidiary's property, payroll and sales but the apportionment percentage in the second example (*i.e.*, for the foreign subsidiary) does not include that subsidiary's property, payroll and sales.

The same is true for each of the other examples included in Respondents' Appendix C – in each example the tax due on the element of foreign commerce would be higher if the subsidiary paying the royalties or interest were a foreign corporation as opposed to a domestic corporation. Thus, Respondents' examples demonstrate that discrimination is inevitable if the unitary royalties and interest are included in the parent's tax base and there is no inclusion in the apportionment computations of the unitary property, payroll and sales that generated such intragroup amounts.

B. Discrimination Inevitably Results Herein When the Proper Comparison is Made Between the Treatment of Foreign Unitary Royalties and Interest Without Factor Representation and the More Favorable Treatment of Domestic Unitary Royalties and Interest With Factor Representation.

Rather than attempting to take head on the irrefutable point that a corporation will always pay more tax on royalties and interest received from a foreign unitary subsidiary than on royalties and interest received from a domestic unitary subsidiary, Respondents have attempted to divert this Court's attention by erroneously shifting the focus to matters not at issue in this case. Respondents allege that in determining whether foreign commerce is impermissibly burdened, all of the provisions of the Business Profits Tax must be taken into account and that "[w]hen both the apportionment formula and the entire tax base are considered, it is not possible to establish that the Business Profits Tax will be higher for a parent corporation with a foreign subsidiary than for a parent corporation with a domestic subsidiary." Resp. Br. at 13-14.[2]

In effect, Respondents' argument reduces to the notion that New Hampshire law may discriminate against royalties and interest paid by foreign unitary subsidiaries because another aspect of the state's tax scheme arguably benefits the taxpayer by not imposing forced worldwide

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[2] All references to "Resp. Br." are to Respondents' Brief in Opposition. References to "Pet." are to the Petition for a Writ of Certiorari.

combination.[3] However, as *Associated Industries of Missouri v. Lohman*, 511 U.S. 641 (1994), demonstrates, a state may not discriminate in any portion of its taxing scheme even if the taxpayer receiving the discriminatory treatment could enjoy unrelated benefits under other provisions of the same scheme.

In *Associated Industries*, this Court considered Missouri's use tax on goods purchased out-of-state at a statewide rate that was greater than the sales tax rate in some but not all localities. Because the use tax rate was equal to or lower than the sales tax rate in some localities, there were many situations in which the tax was not discriminatory. In fact, "in the aggregate, the tax scheme imposed greater burdens on intrastate than on interstate commerce." *Id.* at 646. However, the fact that the tax was discriminatory in some situations compelled this Court to strike down the tax in its discriminatory applications.

Unconstitutional discrimination in one aspect of a tax scheme cannot be cured by an attempt to dampen or mute the discrimination through another part of the tax law. In this case, focusing on Respondents' inclusion of royalties and interest from foreign unitary subsidiaries in the tax base without allowing factor representation in *every* circumstance produces a discriminatory result. Consequently, this particular aspect of the tax scheme is unconstitutional and must be struck down.

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[3] Respondents are confused. Under worldwide combination, income and losses of foreign subsidiaries paying no dividends, no royalties and no interest would be included in the apportionable tax base. That situation has no relevance to this case.

II.

RESPONDENTS' SUGGESTION THAT ROYALTIES AND INTEREST ARE NOT TREATED THE SAME AS DIVIDENDS HAS NO RELEVANCE TO THE FOREIGN COMMERCE CLAUSE DISCRIMINATION ANALYSIS

Respondents attempt to camouflage the discrimination in this case by arguing that royalties and interest are treated differently than dividends for constitutional purposes. Resp. Br. at 17-19. Respondents' assertion is inconsistent with the stipulation in this case, their own administrative rules and with this Court's decision in *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982).

The parties have stipulated that all of the constituent members of the Caterpillar Unitary Business, including the Foreign Unitary Members, are engaged in the conduct of a single, integrated unitary business. Stip. ¶ 1. This stipulation assumes that the form of the intra-unitary group payments, including dividends, royalties or interest, is not important.

Moreover, Respondents' own administrative rules acknowledge that the form or character of an intragroup payment of intangible income is not relevant for purposes of taxation under the unitary business principle. Under these administrative rules, all intragroup payments within the water's edge combined group, regardless of their characterization, are "eliminated" and treated as if they had not been made, for purposes of determining the income of the group that is apportionable to, and taxable by, New Hampshire. N.H. Code Admin. R. Rev. 307.06(d) (currently, N.H. Code Admin. R. Rev. 307.07(c)).

Respondents' assertion also ignores this Court's ruling in *ASARCO* that intangible income of types other than dividends merit the same fundamental constitutional protections. *ASARCO* involved not only whether dividends

from ASARCO's out-of-state and foreign subsidiaries were includable in its apportionable base, but also whether interest and capital gains were so includable. This Court found that ASARCO was not engaged in a unitary business with its out-of-state and foreign subsidiaries that generated the dividend, interest and capital gains, and therefore the amounts were not includable in its apportionable tax base. This Court saw no justification for different constitutional protections between dividends on the one hand, and other types of income from intangibles (such as interest) on the other:

> Idaho and ASARCO agree that interest and capital gains income derived from [ASARCO's subsidiaries] should be treated in the same manner as the dividend income. We also agree. *"One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability."*

ASARCO, 458 U.S. at 330 (citations and footnote omitted, emphasis added).

Therefore, the fact that an intragroup payment is characterized as a dividend, royalty or interest, does not have relevance to the analysis in this case. This is because – as the stipulation in this case, Respondents' administrative rules, and fundamental constitutional principles all confirm – the form of an intragroup payment of intangible income is not relevant for purposes of taxation under the unitary business principle.

III.

THE DENIAL OF CERTIORARI IN CATERPILLAR'S MINNESOTA CASE SHOULD HAVE NO BEARING ON THIS PETITION

Respondents, at Resp. Br. at 9-11, make much of this Court's denial of certiorari in *Caterpillar, Inc. v. Commissioner of Revenue*, 568 N.W.2d 695 (Minn. 1997), *cert.*

denied, 522 U.S. 1112 (1998) ("*Caterpillar Minnesota*"), contrary to principles espoused by this Court numerous times regarding the denial of certiorari. *See, e.g., United States v. Carver*, 260 U.S. 482, 490 (1923) ("[t]he denial of a writ of certiorari imports no expression upon the merits of the case, as the bar has been told many times").

Despite Respondents' contentions to the contrary, the denial of certiorari in *Caterpillar Minnesota* does not mandate a similar denial in this case. This Court has a history of granting certiorari in cases where the identical issue was presented previously but certiorari was denied. For example, in *National Private Truck Council, Inc. v. Oklahoma Tax Commission*, 515 U.S. 582 (1995), this Court granted certiorari to resolve a conflict among state courts regarding remedial relief for Commerce Clause violations under 42 U.S.C. § 1983, where certiorari previously had been denied in a case involving the identical issue. *See id.* at 585-86 (citing *Murtagh v. County of Berks*, 634 A.2d 179 (Pa. 1993), *cert. denied*, 511 U.S. 1017 (1994)); *see also Board of County Comm'rs v. Umbehr*, 518 U.S. 668 (1996) (certiorari granted to resolve conflict among federal courts regarding First Amendment issue where certiorari on same issue was previously denied); *General Tel. Co. of Northwest, Inc. v. EEOC*, 446 U.S. 318 (1980) (certiorari granted to resolve conflict among federal courts regarding Title VII class action issue where certiorari on same issue was previously denied); *Jackson v. Denno*, 378 U.S. 368 (1964) (certiorari granted to resolve conflict among state courts regarding Fourteenth Amendment issue where certiorari on same issue was previously denied).

Given the current conflict among the state courts regarding factor representation, and given the importance of this issue to the states as well as to taxpayers, this Court should grant certiorari on this Petition.

Moreover, this case more clearly demonstrates, than did *Caterpillar Minnesota*, the blatant facial discrimination that exists against foreign commerce. As illustrated in the instant Petition (Pet. at 3), the resulting tax inevitably increases when a parent corporation moves a subsidiary located exclusively in Maine across the St. Lawrence River to Quebec. *See Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin.*, 505 U.S. 71, 74 n.10 (1992).

Furthermore, this case more clearly emphasizes the two-part test of the unitary business principle. As discussed in the Petition, either New Hampshire should not include the foreign royalties and interest in the tax base (Part A of the unitary business principle) or, if it includes such unitary payments in the base, it should include the factors of the unitary corporations that generated such amounts in the calculation of the apportionment formula (Part B of the unitary business principle).

Therefore, the denial of certiorari in the Minnesota case should have no bearing on this Petition.

IV.

RESPONDENTS' BRIEF CONTAINS OTHER INCORRECT ASSERTIONS CONCERNING THIS CASE

Respondents make other incorrect assertions concerning this case. Respondents incorrectly assert that Petitioners are attempting to "substantially broaden" their constitutional claims before this Court. Resp. Br. at 8-9. This is not true. Petitioners have always asserted that the Department's inclusion of the foreign unitary royalties and interest in Caterpillar's apportionable tax base, without including the foreign unitary apportionment factors that generated such income in the denominator of the apportionment formula, discriminates against foreign commerce.

Respondents, perhaps recognizing their vulnerability with respect to the defenses they attempt to raise concerning the merits of their constitutional position, incorrectly assert that the remedy of exclusion of the foreign unitary income from the tax base was abandoned by Petitioners. Resp. Br. at 16 n.10. This is not true, as is demonstrated by Respondents' failure to refer to any part of the record to support their incorrect assertion. Petitioners have always objected to the state's overreaching and its modification of the unitary business principle. Moreover, Petitioners are not asking this Court to fashion a remedy to the discrimination but have merely indicated that there are remedies that comport to constitutional taxation.

Respondents are also incorrect, as was the court below, when they state that royalties and interest received from the Foreign Unitary Members are the same as royalties and interest received from third parties. Resp. Br. at 7-8. The royalties and interest received from the Foreign Unitary Members, if includable at all in Caterpillar's New Hampshire tax base, are includable only because of the existence of the stipulated unitary relationship. Payments from third parties, however, never satisfy the unitary business relationship requirement. Moreover, royalties and interest received from third parties can serve an investment function of the recipient corporation. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 787 (1992). Therefore, Respondents' statements that all payments by unrelated third parties would be includable in the apportionable tax base are incorrect.

The final and most misleading claim made by Respondents is that Petitioners are challenging New Hampshire's use of water's edge combination rather than worldwide combination. Resp. Br. at 20-23. This is a gross mischaracterization of Petitioners' challenge. Petitioners

agree wholeheartedly with the policy concerns that caused New Hampshire (and other States) to abandon taxation on a "worldwide combination" basis in favor of a "water's edge" system. Petitioners' complaint is that New Hampshire's water's edge system violates the Foreign Commerce Clause because of its inconsistent application of the unitary business principle. By including the royalties and interest of the Foreign Unitary Members without the same apportionment allowed to income of the Domestic Unitary Members, New Hampshire is disregarding the unitary business principle and, therefore, is engaging in discriminatory, extraterritorial taxation against foreign commerce. It is this disregard of the unitary business principle to which Petitioners object.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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